S. Hrg. 100-692

S. 2259, THE PREFERRED SURETY BOND GUARANTEE PROGRAM ACT OF 1988

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

SECOND SESSION

ON

S. 2259

THE PREFERRED SURETY BOND GUARANTEE PROGRAM ACT OF 1988

APRIL 12, 1988

Printed for the use of the Committee on Small Business

U.S. GOVERNMENT PRINTING OFFICE
86-663 WASHINGTON : 1988

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

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April 12, 1988:

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S. 2259, THE PREFERRED SURETY BOND GUARANTEE PROGRAM ACT OF 1988

TUESDAY, APRIL 12, 1988

U.S. SENATE,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The Committee met, pursuant to notice, at 9:20 a.m., in room SR-428A, Russell Senate Office Building, Hon. Sam Nunn (Acting Chairman) presiding.

STATEMENT OF HON. SAM NUNN, A U.S. SENATOR FROM THE STATE OF GEORGIA

Senator NUNN. The Committee will come to order.

This morning the Committee meets to receive testimony on S. 2259, the Preferred Surety Bond Guarantee Program Act of 1988. My purpose in introducing this bill along with Senator Weicker, Senator Bumpers, and Senator Boren is to expand the potential of the Small Business Administration program that is becoming increasingly vital to more and more small business construction contractors and subcontractors. That program is the SBA Surety Bond Guarantee Program.

Without access to adequate bonding, construction firms large and small cannot operate. Without the performance bonds and payment bonds required by the Miller Act, you are foreclosed from performing any Federal project in excess of $25,000.

Most State and local governments have similar requirements. Commercial purchases of construction are requiring bonds more frequently and are being urged to expand their use yet further. Similarly, prime contractors are being urged to require bonds from their subcontractors.

At the same time that the broader use of surety bonds is being advocated, the surety bond industry is retrenching, 1986 was a year of record losses. When the numbers are all in, 1987 is expected to be only marginally better. The tightening of the bonding market was the focus of a recent cover story in ENR magazine.

Many contractors are in for trouble, according to the executive vice president of the National Association of Surety Bond Producers, Bruce T. Wallace. There is a lot of excess construction capacity out there that has to be weeded out, according to Mr. Wallace.

Dennis Wine, the general counsel of the Surety Association of America, whose president will testify today, noted that solid contractors can still obtain bonds with a minimum of effort, while the less viable firms can expect to find it difficult or near impossible.

He equated it to dating. Quoting him, "The pretty girls have six guys on their doorstep. My advice is to get prettied up."

When the length of a firm's history, the depth of its financing and the experience of its managers are some of the criteria used to make the decision to bond, many small firms find it almost impossible to get prettied up. Small firms are likely to be the first ones to get weeded out.

The situation of small firms owned and controlled by socially and economically disadvantaged persons will be even worse. The SBA Surety Bond Guarantee Program is the means to overcome the surety industry's perception that many small firms are just too risky to bond.

In the words of the statement of the American Subcontractors Association, the program has been the small firms' principal lifeline to reaching the bonds that they must obtain if they are to survive and ultimately grow. If perceived risk is the problem, the best solution is to lower the risk.

The Surety Bond Guarantee Program does just that by guaranteeing the participating surety against the majority of its potential loss up to 80 percent under current SBA rules. To protect the taxpayer, the SBA reviews and approves the actions of the participating surety company throughout the process from evaluation of bond applications to payments of any claims.

The small business construction community has made good use of the program since it was authorized by Congress in 1971. In all, over 200,000 contracts valued at more than $17 billion have been bonded.

The program has had some very difficult times, especially during the late 1970s and early 1980s. In 1982, Senator Weicker, you held extensive and revealing oversight hearings in this area. Those hearings came on the heels of an equally critical GAO report in 1979 and a whole series of unfavorable SBA Inspector General Reports.

However, according to a follow-up 1986 General Accounting Office review requested by this Committee, most of the program problems appear to be behind us.

But there has been one residual problem: The continued reluctance of the so-called standard surety companies, the very largest players in the industry, to participate in the SBA Surety Bond Guarantee Program.

Initially, the standard surety companies participated, but their participation declined rapidly in the face of the program's management problems and scandals. Almost all the bonds guaranteed through the program are written by a group of firms organized to meet the program needs, the so-called specialty surety firms. We will be hearing from their representatives as well, since we certainly do not want to impede their continued participation through this bill. That participation has been vital for many small businesses.

S. 2259 can trace its origins to discussions with the standard surety companies initiated by SBA during the early 1980s aimed at fostering their return to the program. The result of those discussions came to be called Plan B.

The bill's approach is simple and direct: Establish on a 3-year pilot basis a preferred Surety Bond Guarantee Program akin to the

Preferred Lender Program that has helped the SBA's Guaranteed Loan Program. SBA would only review and approve a preferred surety's standards and procedures. Individual actions would be handled without any prior SBA approvals.

In the jargon of the industry, the preferred surety would be given "the pen" to write bonds with the SBA guarantee. To demonstrate that they will use the pen prudently, the firms are willing to accept a lesser guarantee, a maximum of 70 percent as opposed to the present law.

To further protect the taxpayer, firms would have to meet a very stringent set of standards to be designated as a preferred surety.

The Preferred Surety Program is expected to be helpful to small disadvantaged firms, since the standard sureties plan to focus on meeting their needs. Broadening the bonding opportunities for small disadvantaged firms is one of my principal goals in introducing this legislation, and I think I can speak for all the other cosponsors in this respect.

To further encourage the bonding of small disadvantaged firms, S. 2259 provides a 90-percent guarantee on bonds to such firms under the regular Surety Bond Guarantee Program. If small disadvantaged firms cannot obtain needed bonding because they are perceived as even greater risk by the sureties, the solution seems to be to lower the sureties' risk still further.

As we hear today's witnesses, I urge you to keep in mind the market situation I alluded to earlier, a bonding market with diminished capacity and tightening underwriting standards coupled with advocacy for increased use of bonds in private commercial work and between prime contractors and their subcontractors.

To me, the convergence of these two trends suggests real trouble, and most of the trouble will come to small firms and small disadvantaged firms. Thus, it is very timely that this committee, working with all segments of the surety industry, the SBA and the consumers of the SBA guaranteed bonds, takes positive steps to improve the SBA Surety Bond Guarantee Program.

I believe that S. 2259 is a solid beginning, but I would urge witnesses today to share with the Committee your ideas for other program improvements while offering your assessments of the bill, both pro and con.

Senator Weicker, you have been involved in this area for a long time, and we would love to hear from you this morning before we hear from the witnesses.

STATEMENT OF HON. LOWELL WEICKER, JR., A U.S. SENATOR FROM THE STATE OF CONNECTICUT

Senator WEICKER. Thank you very much, Mr. Chairman. I want to commend you on your introduction of this legislation.

This is legislation on which Senator Nunn has been the prime mover, and he has been supported in that effort by Chairman Bumpers and myself.

The legislation is designed to provide more avenues for small and minority contractors to pursue in their search for essential bonding.

Under Federal law, firms must be bonded in order to bid and perform on Government contracts, and all too often job opportunities are lost because small contractors are simply unable to obtain bonding from standard or specialty surety companies.

Thus, the objective of this legislation is to broaden the supply of surety companies that participate in the SBA program by attracting so-called standard surety companies, including such companies as The Hartford, the Aetna, and the Travelers, to name a few of the large companies from my home State. We hope to provide more capacity for small businesses and particularly minority businesses to obtain essential bid, performance, and contract bonds.

I ask that the remainder of my statement be placed in the record at this point.

[The prepared statements of Senators Weicker, D'Amato, and Dixon follow:]

OPENING STATEMENT OF SENATOR LOWELL WEICKER,JR.
-AT
SMALL BUSINESS COMMITTEE HEARING ON S. 2259

TODAY, THE COMMITTEE WILL HOLD A HEARING ON S. 2259, LEGISLATION WHICH SENATOR NUNN, CHAIRMAN BUMPERS AND I HAVE INTRODUCED TO PERMIT THE SMALL BUSINESS ADMNINISTRATION(SBA) TO CONDUCT A "PREFERRED SURETY BOND PROGRAM". THE LEGISLATION IS DESIGNED TO PROVIDE MORE AVENUES FOR SMALL AND MINORITY CONTRACTORS TO PURSUE IN THEIR SEARCH FOR ESSENTIAL BONDING. UNDER FEDERAL LAW, FIRMS MUST BE BONDED IN ORDER TO BID AND PERFORM ON GOVERNMENT CONTRACTS. ALL TOO OFTEN, JOB OPPORTUNITIES ARE LOST BECAUSE SMALL CONTRACTORS ARE SIMPLY UNABLE TO OBTAIN BONDING FROM STANDARD OR SPECIALITY SURETY COMPANIES.

THUS, THE OBJECTIVE OF THIS LEGISLATION IS TO BROADENED THE SUPPLY OF SURETY COMPANIES THAT PARTICIPATE IN THE SBA PROGRAM. BY ATTRACTING THE SO-CALLED STANDARD SURETY COMPANIES, INCLUDING SUCH COMPANIES AS THE HARTFORD, THE AETNA AND THE TRAVELERS, TO NAME A FEW OF THE LARGE COMPANIES FROM MY HOME STATE, WE HOPE TO PROVIDE MORE CAPACITY FOR SMALL BUSINESSES AND PARTICULARLY MINORITY BUSINESSES TO OBTAIN ESSENTIAL BID, PERFORMANCE AND CONTRACT BONDS. THROUGH THE ASSOCIATIONS THAT THE SMALL CONTRACTORS MAKE THROUGH THIS PROGRAM WE HOPE THAT IT WILL HELP THEM TO BRIDGE THE GAP THAT SEVERAL FIRMS EXPERIENCE WHEN THEY ARE NO LONGER ELIGIBLE FOR ASSISTANCE FROM THE SBA PROGRAM.

TO SHOW THE IMPORTANCE THAT THIS PROGRAM HAS GAINED OVER THE YEARS, IN THE SUMMER OF 1986 THE SBA HAD TO SHUT THE PROGRAM DOWN EARLY IN ORDER NOT TO RUN OUT OF AUTHORITY OR TO OVERCOMMIT. DURING THE HEIGHT OF THE CONSTRUCTION SEASON, OFFICES WERE FLOODED WITH CALLS FOR CONTRACTORS DESPERATE FOR THE CONGRESS TO ACT TO INCREASE THE AUTHORIZED CEILING SO THAT THE PROGRAM WOULD NOT SHUT DOWN. WHEN OTHER SBA CREDIT ASSISTANCE PROGRAMS SUFFERED FROM THE ADMINISTRATION 2 YEAR ASSAULT ON THE AGENCY, THE DEMAND FOR THIS PROGRAM EXCEEDED THE AUTHORIZED LEVELS.

THIS HEARING ALSO IS THE FIRST TIME THAT THE COMMITTEE HAS HAD AN OPPORTUNITY TO REVIEW SPECIFICALLY THE OPERATION OF THE SURETY BOND PROGRAM SINCE 1982 WHEN I CHAIRED HEARINGS AFTER STAFF INVESTIGATIONS REVEALED THAT THE PROGRAM WAS BEING ABUSED BY MEMBERS OF ORGANIZED CRIME. ACCORDING TO A REPORT THAT THE COMMITTEE RECEIVED FROM THE GAO THE PROGRAM'S OPERATIONS HAVE IMPROVED SIGNIFICANTLY SINCE THOSE HEARINGS. ONE OF THE OBSERVATIONS THAT I RECALL MAKING THEN WAS THAT THE PROGRAM COULD BE SIGNIFICANTLY IMPROVED BY GREATER INVOLVEMENT OF THE STANDARD COMMERCIAL SURETY COMPANIES. I AM PLEASED THAT WE ARE CONSIDERING THIS CONCEPT TO DO THAT. I LOOK FORWARD TO THE TESTIMONY THAT WE WILL RECEIVE TODAY AND TO WORKING WITH SENATOR NUNN AND CHAIRMAN BUMPERS TO SEE THAT THE CONCEPT PASSES THE SENATE AND IS ENACTED INTO LAW.

STATEMENT BY SENATOR ALFONSE M. D'AMATO
BEFORE THE SMALL BUSINESS COMMITTEE
THE PREFERRED SURETY BOND GUARANTEE PROGRAM
APRIL 12, 1988

MR. CHAIRMAN, I WOULD LIKE TO WELCOME TO THE SMALL BUSINESS COMMITTEE THIS MORNING OUR DISTINGUISHED PANEL OF WITNESSES WHO WILL PRESENT THEIR VIEWS ON THE PREFERRED SURETY BOND GUARANTEE PROGRAM, S. 2259.

THE SBA SURETY BOND GUARANTEE PROGRAM WAS CREATED IN 1971 TO PROVIDE THE ASSISTANCE NEEDED FOR SMALL FIRMS TO OBTAIN NECESSARY BONDING. AS PROVIDED IN THE ACT, THE SBA HAS AUTHORITY TO REVIEW AND APPROVE THE APPLICATIONS OF SMALL BUSINESSES BEFORE THE SURETY FIRM CAN ISSUE THE BOND WITH THE SBA GUARANTEE. IN RECENT YEARS, MANY OF THE STANDARD SURETY FIRMS DECLINED TO PARTICIPATE IN THE SBA PROGRAM CITING BURDONSOME ADMINISTRATIVE PROCEDURES ASSOCIATED WITH THE SBA REVIEW PROCESS IN APPROVING EACH BOND GUARANTEE.

SINCE THAT TIME, THIS COMMITTEE HAS EXPLORED WITH THE SUREY FIRMS WAYS IN WHICH THE PROGRAM CAN BE CHANGED SO THAT BUREAUCRATIC RED TAPE IS MINIMIZED. THE CHANGES HAVE TAKEN

THE FORM OF THE LEGISLATION WHICH THE COMMITTEE IS DISCUSSING THIS MORNING. THIS LEGISLATION CREATES A PREFERRED SURETY BOND PROGRAM WHICH WOULD ALLOW SURETY COMPANIES THAT MEET STRICT SBA GUIDELINES TO BE RELIEVED OF THE REVIEW AND APPROVAL REQUIREMENTS FOR EACH BOND APPLICATION. THE SURETY FIRMS WOULD BE GIVEN EXPANDED UNDERWRITING CAPABILITIES THAT MEET THE APPROVAL OF THE SBA.

THE REFORMS EMBODIED IN THIS LEGISLATION ARE ESPECIALLY IMPORTANT TO MINORITY CONTRACTORS WHO HAVE HAD A VERY DIFFICULT TIME IN OBTAINING BONDING.

I LOOK FORWARD TO THE TESTIMONY OF OUR WITNESSES THIS MORNING AND TO THEIR INVALUABLE INSIGHT INTO THE REFORMS OUTLINED IN S. 2259.

THANK YOU, MR. CHAIRMAN.

APRIL 12, 1988

STATEMENT BY SENATOR ALAN J. DIXON

COMMITTEE ON SMALL BUSINESS

HEARING ON PREFERRED SURETY BOND GUARANTEE PROGRAM ACT OF 1988

S. 2259

I AM PLEASED THAT MY GOOD FRIEND SENATOR NUNN IS CHAIRING TODAY'S HEARING ON THE SUBJECT OF SURETY BONDS. THE ABILITY TO SECURE BID, PERFORMANCE AND PAYMENT BONDS IS CRUCIAL TO ALL BUSINESSES. WITHOUT BONDS QUALIFIED COMPANIES CANNOT PERFORM CONTRACTS. WITHOUT CONTRACT EXPERIENCE SURETY FIRMS ARE RELUCTANT TO PROVIDE BONDS. THIS CIRCLE OF FRUSTRATION IS ESPECIALLY ACUTE FOR THE SMALL BUSINESSES OF OUR NATION WHICH FREQUENTLY LACK THE EXPERIENCE AND SIZE NECESSARY TO GET THE ATTENTION OF THE SURETY COMPANIES.

FORTUNATELY, THE SBA CAN RESOLVE THIS DILEMMA THROUGH ITS SURETY BOND PROGRAM. UNFORTUNATELY, THE SO-CALLED STANDARD SURETY COMPANIES HAVE CHOSEN NOT TO PARTICIPATE IN THE PROGRAM BECAUSE OF GOVERNMENT RED TAPE, DELAYS IN PROCESSING, AND SECOND GUESSING OF SURETY COMPANY JUDGMENTS. THE LEGISLATION INTRODUCED BY SENATOR NUNN WHICH WE ARE CONSIDERING TODAY PROVIDES AN INNOVATIVE APPROACH TO THE PROBLEM.

ESTABLISHING A PREFERRED SURETY BOND PROGRAM SIMILAR TO THE PREFERRED LENDER PROGRAM IS IMPORTANT TO PROVIDING MORE BONDING CAPACITY TO SMALL BUSINESSES. THOSE SURETY COMPANIES WHICH MEET PRESCRIBED STANDARDS WILL BE DESIGNATED "PREFERRED" SURETY BOND UNDERWRITERS. AS SUCH THEY WILL BE CAPABLE OF PROCESSING SBA SURETY BOND APPLICATIONS MORE QUICKLY, WITH LESS COST, AND WITH MORE CERTAINTY. THESE SIGNIFICANT BENEFITS WILL HOPEFULLY ATTRACT MORE COMPANIES TO THE SBA SURETY PROGRAM AND CONSEQUENTLY EXPAND THE QUANTITY OF BONDS AVAILABLE TO SMALL BUSINESSES.

I LOOK FORWARD TO THE TESTIMONY PRESENTED ON THIS IMPORTANT SUBJECT FROM OUR PANELISTS. AND I CONGRATULATE SENATORS NUNN, BUMPERS, WEICKER, AND BOREN FOR PURSUING A MUCH NEEDED REMEDY TO THE SMALL BUSINESS BONDING PROBLEM.

Senator **Weicker**. Mr. Chairman, I have a further commitment that will require me to leave. I want to stay for a few minutes. Again I want to compliment you on taking something which is very unheralded, and I am sure has very little meaning to the public at large but which is essential to the small businesses of this Nation, and following through on it.

I can assure you have my support not just to have a hearing but to also have a law. I think the chances for that are very good this year.

Senator **Nunn**. Thank you very much, Senator Weicker. You have been, of course, an outstanding and consistent champion for both small businesses, in general, and disadvantaged firms, in particular. We thank you for your participation and leadership in this Committee and on this particular piece of legislation.

Our first panel this morning is Mr. Edward W. Bowen, Jr., managing director, Cornerstone Financial Group, Atlanta, GA. He is representing the National Association of Minority Contractors, accompanied by Mr. Ralph Thomas, executive director, National Association of Minority Contractors; and Mr. M.R. Sullivan, executive vice president, Sullivan Mechanical Contractors from Virginia. Mr. Sullivan is representing the American Subcontractors Association.

I do not see Mr. Thomas, so Mr. Bowen and Mr. Sullivan, we are delighted to have you this morning. We will be pleased to receive your statement, and then we will have some questions.

Mr. Bowen, would you like to lead off?

Mr. **Bowen**. Yes, sir, Senator.

STATEMENT OF EDWARD W. BOWEN, JR., MANAGING DIRECTOR, CORNERSTONE FINANCIAL GROUP, ATLANTA, GA, ON BEHALF OF THE NATIONAL ASSOCIATION OF MINORITY CONTRACTORS

Mr. **Bowen**. Good morning. First of all, with great pleasure I appear before this Committee and thank you, Senators Nunn and Weicker, for sponsoring this legislation. I think it is long overdue and well needed by the minority contractors and small contractors in general throughout the country.

One of the major problems with the Small Business Administration's Surety Bond Guarantee Program historically has been the lack of participation on the part of the major surety companies. Oftentimes the question is asked why is that important.

During the early years of the Surety Bond Guarantee Program, some of the specialty surety companies, because of their lack of capital or their low capital base, found themselves unable to write bonds for small contractors that were in excess of the SBA statutory limit.

The SBA's limit on a contract was originally at $500,000. It was increased to $1 million and recently was increased to $1,250,000. When a small contractor grows outside of the SBA guarantee limit, he finds it extremely difficult to graduate into the market such that he can continue to bid the projects and perform projects that may be set aside for him if he is in the SBA 8(a) Program.

One of the major problems with the 8(a) contractors throughout the country has been this issue of graduation into the standard market. The standard companies have been unwilling, as has been stated, to participate with the SBA program because of the constraints of the paperwork and the cost of doing business with the SBA.

Also, SBA historically has had a low staffing compared to the large applications that they have received throughout the country. I spent 10 years in the Surety Bond Guarantee Program and resigned in 1983. At the time I left the Government, I think the staff throughout the country may have been about 50 people, of which maybe 25 were professionals and the rest, of course, were clerical.

When you are faced with a voluminous amount of applications for guarantee, it is impossible for the SBA staff to review those applications and make a quality underwriting decision in a timely manner.

With this program, the standard sureties that are very experienced in underwriting this type of bond can make a decision, issue the bond, and control the loss such that SBA will not have to spend its dollars paying off losses to supplies, subcontractors and finishing projects for contracts that went into default.

This is a needed piece of legislation. Hopefully it will bring Aetna, The Hartford, and Travelers into this program such that they can work with the small disadvantaged contractors from the inception to a point where they can graduate into these companies.

These sureties can lend their expertise to the small contractor and make him more viable. They also can reduce the cost to the SBA through their means of controlling loss expenses once a contractor has been placed in default.

One of the problems that we experienced during my years with SBA was the fact that certain specialty sureties had to utilize outside counsel in order to mitigate the loss exposure to the surety and to the SBA.

Oftentimes, the lawyers, accountants, and adjusters associated with resolving a claim spent more time than necessary in order to pay off a loss or resolve a dispute, which meant additional exposure to the SBA ultimately.

I think this legislation will help in reducing that loss exposure. I think this legislation will open up the standard markets to the small minority contractors and small contractors in general. I think this legislation will go a long way toward helping the SBA deal with the problems they have with managing a major program with a limited amount of staff.

It has taken quite a while to get to this point of introducing this particular legislation. I have been very encouraged in conversations I have had both with the SBA and the representatives of the Surety Association of America that they will make a concerted effort to work with the small contractor, to work particularly with the small disadvantaged contractor.

I think that is a program that is well worth supporting, and in that respect we lend our full support to this particular act.

[The prepared statement of Mr. Bowen follows:]

STATEMENT BY

EDWARD W. BOWEN, JR.
Managing Director
Cornerstone Financial Group

On Behalf of the National Association of Minority Contractors

ON

THE PREFERRED SURETY BOND GUARANTEE ACT OF 1988

Washington, D.C.
April 12, 1988

SUMMARY

Increased participation by major surety companies will:

- Improve underwriting experience and loss control;
- Offer rates at levels equal to those provided by the standard market. No collateral fees, expenses, or unorthodox pledges;
- Improve graduation results;
- Improve cost reductions and efficiencies to SBA/SBG, surety, producer and client;
- Expedite action on needs of clients on bidding and other immediate matters; and,
- Provide fair and timely resolution of bond claims expenses and improve salvage results.

Edward W. Bowen, Jr. - Managing Director of Cornerstone Financial Group, former Senior Underwriter of the Small Business Administration's Surety Bond Guarantee Program.

My statement is offered as a commentary on Preferred Surety Bond Guarantee Program Act of 1988 to encourage expanded participation in the SBA Surety Bond Guarantee Program by standard surety companies.

The Small Business Administration's Surety Bond Guarantee Program (SBG) originated in 1971, after the Congress of the United States asked the Department of Housing and Urban Development to conduct a study to help assure "adequate availability of surety bonds for construction contractors in urban areas".

At the inception of the Surety Bond Guarantee Program (SBG), the Surety Association of America (which represents over five hundred insurance companies engaged in suretyship business) along with several standard surety companies, assisted the SBA in structuring an acceptable guarantee agreement and furthermore pledged their full support of the program. Unfortunately this pledge of support never resulted in standard sureties actively participating in the SBA/SBG Program, leaving ninety-eight percent (98%) of the SBG portfolio in the hands of small, undercapitalized insurance companies.

The high percentage of business being underwritten by a limited number of small insurance companies has created great concerns to the SBA. These concerns are well founded since during the existence of the SBG Program several participating companies have filed for receivership, leaving various creditors, subcontractors, laborers and materialmen unpaid. In addition, small contractors, particularly concerns that are owned and controlled by small and disadvantaged individuals, have been left without adequate sources for contract bonds.

During the 16 year period since its inception, the Surety Bond Guarantee Program has undertaken to widen the accessibility of surety bonds to contractors who otherwise had difficulty in obtaining same through the conventional market. The Program has demonstrated that it is far superior to any other means or devices either at the federal or local levels to assist contractors in obtaining bonded work, at the same time attempting to assure that the public interest is served through prequalification procedures, that ensure competent and qualified contractors being engaged to perform the work acquired.

Nonetheless, it is recognized that any Program such as the Surety Bond Guarantee Program addressing itself to socially complex challenges elusive of clear cut solutions, can be subject to many kinds of problems and criticisms in the course of its performance.

While the intent of the Program is to service small business contractors, it has been observed by the Senate Oversight Committee, the GAO and others that a certain portion of the clientele is now comprised of those who either do not suffer such disadvantages, are otherwise bondable in a conventional market, or who should not be bonded at all. The major writers of surety bonds firmly believe that their staffing and production/underwriting network provides both the professionalism and sensitivity to better meet the intended goals of SBA/SBG.

The costs and expenses of production/underwriting/claims servicing are factors that have influenced the strategy and styles of all participating companies. In some instances, cost efficiencies have been found to have inhibited the observance of standard underwriting practices as well as resulting in inferior claims servicing. Conversely, prohibitive administrative and processing costs incurred in the development of this business has deterred many otherwise interested writers and producers. This will continue to be the trend, and will operate to the further detriment of the entire Program under existing conditions if they remain unchanged.

Underwriting decision-making presently is jointly vested between the producing company and SBA personnel. Sound underwriting decisions, and particularly those involving the marginal clientele having difficulty qualifying in the conventional surety market, require the utmost in professional judgement gained only by years of experience. All underwriting decisions in the hands of those that are best qualified, backed by a willingness to assume a commensurate portion of the risk, with the SBA enforcing the adherence to pre-established procedures, would substantially improve upon and not deteriorate from both the acceptable level of qualified clientele and loss experience. The development and implementation of such procedures that embrace the concepts of this proposal would focus proper attention on SBA/SBG overseeing the conformity by the participating companies to the terms of this Plan.

There is some degree of truth that excessive paperwork and second guessing by SBA created resentment by standard surety companies toward the Surety Bond Guarantee Program. However, this problem is not solely with the companies, but also with the American agency system which produces contract surety bonds and insurance for the insurance industry.

Since there are a small number of companies writing contract surety bonds, there are an equally small number of agents who specialize in bonding. Small relatively sound contractors who have never performed a job which required a bond have gone to their broker or agent who sold them their car or truck insurance. Rather than lose the business of the good contractor, the agent may report that the insurance company he represents is not interested in the business. That may be a half truth. The insurance company may have no surety department and would not be interested in anyone's surety needs. Once a small contractor has found the right surety agent, the time and attention required will cause the agent to lose money in processing the application. The agent or broker does not earn a fee unless the contractor is the low bidder and secures his payment and performance bond from the agent/broker. This means a large commitment in time is made by the agent on behalf of the bond applicant on the speculation that the contractor will be low bidder and awarded the job and secure all his needed bonding and insurance from the agent/broker. The surety pays the agent/broker a commission in the form of a share in the surety bond premium. It should be noted that it takes the same amount of time and attention to underwrite the large contractor as it does for the small contractor. Since premium/commission income is greater from the large bonded contractor than the small agents and surety companies which specialize in contract bonding concentrate on serving the needs of the major contractors. Agents/brokers who represent the SBA specialty sureties, often times don't have agency relationships with the standard surety companies. Therefore they are unable to place a small contractor with a standard surety company. This leaves the small contractor without an adequate source for bonding on projects in excess of $1,250,000, and further causes a strain on the Surety Bond Guarantee budget due to a lack of graduation.

One of the key components of this Preferred Surety Bond Guarantee Program should be the involvement of minority owned insurance agencies into the surety bond market. Such agencies would be knowledgeable of the unique challenges associated with small/minority owned contractors. Moreover, this involvement with the standard surety companies would enhance the effort to educate the minority contractor to the unique requirements of the surety industry as well as create a viable source for bonding minority contractors in the future years.

EDWARD W. BOWEN, JR.

Mr. Bowen has worked with the Small Business Administration Surety Bond Guarantee Program as both a claims adjuster and bond underwriter. As a claim adjuster, he was responsible for developing the Agency's position on each claim, mitigating SBA's exposure, where feasible, pointing out errors and substantive items within claim files which might have led to the Small Business Administration's possible denial of liability. He was responsible for performing studies to identify possible causes of contractor defaults and developed procedures and techniques to be used in attaining better underwriting standards and the consequent prevention of future defaults and claims.

As an Underwriting Analyst, he was responsible for underwriting all Surety Bond Guarantee submission from the field offices for cases over $500,000 in contract value, recommending approval or disapproval on all such cases. He assisted in conducting training of field office Community Economic Development personnel in the SBA`s Surety Bond Guarantee Program. He participated in the training programs by leading discussion and instructing in procedures and techniques to be used in the processing and servicing of applications. He assisted in the development of long range plans for the procedures, policies and staffing levels of the Surety Bond Guarantee Program.

As Senior Underwriter, Mr. Bowen was responsible for advising and assisting SBA field personnel relative to technical policy and procedural questions pertaining to the implementation and maintenance of the Surety Bond Program. In conjunction, he was responsible for reviewing decisions on bond guarantee cases submitted by the field offices to Central Office for either clarification or consideration. He coordinated such activities with sureties, contractors, bond agent/broker associations, and other interested parties. He conducted studies and research in conjunction with the sureties for the development of procedures and techniques to be used by surety and SBA field personnel in the exercise of field guarantee authority. He was responsible for advising and the preparing of the Surety Bond Guarantee Program's SOP. He made recommendations for changes in policy, program emphasis, staffing levels and qualifications, as well as bond guarantee assistance material for use by the general public.

Senator NUNN. Thank you very much, Mr. Bowen.

Mr. Sullivan, we will go ahead and get your statement, and then we will have questions for you both.

We are glad to have you here with us, too.

STATEMENT OF M.R. SULLIVAN, EXECUTIVE VICE PRESIDENT, SULLIVAN MECHANICAL CONTRACTORS, SHENANDOAH, VA, ON BEHALF OF THE AMERICAN SUBCONTRACTORS ASSOCIATION

Mr. SULLIVAN. Thank you for the opportunity.

The American Subcontractors Association is a national trade association representing construction subcontractors, about 80 percent of which are small businesses.

One of the biggest problems facing construction contractors today is the availability of surety bonds. Surety bonds are required by the Federal Government under the Miller Act and by State and many local governments under a myriad of little Miller Acts.

In addition, there are growing trends for private owners to require bonds from their general contractors and general contractors to require bonds from their subcontractors.

Both trends have been fueled by marketing campaigns sponsored by the Surety Association of America and the National Association of Surety Bond Producers. So, if as Cervantes has Don Quixote say, "an honest man's word is as good as his bond," a contractor's word carries the value of a $3 bill unless it is accompanied by some acceptable surety company's product.

In essence, bonding capacity is a literal life or death matter for any construction firm wishing to move beyond very small projects; but at a time of growing demand for bonds, there is a reduced capacity in the market to provide such bonds because of monumental losses suffered by surety companies in recent years.

The construction industry is renowned for the ease of entry by new businesses. It is an industry in which the rate of small business participation outpaces that of almost every other industry. It is an industry dominated by small businesses.

This could all change if the trends of increased demand for bonds and a reduced capacity continue without some kind of concerted effort to make bonding more available for qualified small businesses.

Already all too frequently, small businesses find it difficult if not impossible to obtain the bonding necessary to assure their survival and growth.

Apparently, most sureties have concluded that small contractors are a riskier proposition than large contractors. At the same time, it is nearly as expensive to investigate and prequalify a small contractor as a large contractor.

Whatever the rationale of the surety companies, small business contracting firms who historically have had problems obtaining adequate bonding will in the future have even more serious problems.

One of the lifelines for small business construction firms attempting to obtain adequate bonding in order to survive and grow has been the Small Business Administration's Surety Bond Guarantee Program.

Mr. Chairman, you are to be commended for recognizing the special bonding problems of small businesses and for introducing legislation that would improve the SBG Program so it can help even more small businesses.

ASA supports your bill S. 2259, which is designed to encourage the participation of the so-called standard surety companies in the SBG Program. It does so by reducing the involvement of SBA in the day-to-day approval of bonds.

At the same time, the bill reduces the guarantee to firms participating in the Pilot Program to 70 percent. If sufficiently used, this reduction in the guarantee could allow SBA to write a greater number of bonds under existing guarantee authority.

S. 2259 also would clarify that the SBG Program guarantee authority is a revolving fund. This, too, will allow SBA to increase the number of bonds it provides under the SBG Program.

ASA supports S. 2259 as a step toward addressing the problem of increased demand for bonds coupled with reduced capacity.

ASA also urges this Committee to address the capacity problem by increasing the amount of SBA's guarantee authority from the current $1.25 billion to $1.75 billion. This will allow increased participation by small business firms which are being driven out of the regular surety market.

I urge this Committee to expedite the consideration of this legislation. I and ASA stand ready to help you in any way possible.

Thank you.

[The prepared statement of Mr. Sullivan follows:]

Statement of

AMERICAN SUBCONTRACTORS ASSOCIATION

to the

COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE

on

S.2259
PREFERRED SURETY BOND GUARANTEE PROGRAM ACT OF 1988

April 12, 1988

AMERICAN SUBCONTRACTORS ASSOCIATION 1004 DUKE STREET, ALEXANDRIA, VA 22314-3512
(703) 684-3450

Statement on S.2259, the "Preferred Surety Bond Guarantee Program Act of 1988"

The American Subcontractors Association is a national trade association with more than 7,200 firms representing all major construction trades in 58 chapters.

ASA is the only national organization that speaks exclusively for the interests of construction subcontractors. ASA is dedicated to improving general business conditions for subcontractors through unified and cooperative actions.

One of the biggest problems facing construction contractors today is the availability of surety bonding. This problem is more severe for small business construction contractors because of the operating assumption of surety companies that small construction companies inherently present a greater risk than large construction companies.

Therefore, ASA supports S.2259, the "Preferred Surety Bond Guarantee Program Act of 1988", as an effort to assure that appropriate bonding is available to qualified contractors of all sizes.

The Importance of Bonds

The relationship between the construction industry and bonding companies is almost a century old, although the existence of sureties coincides with the invention of commerce. One of the

AMERICAN SUBCONTRACTORS ASSOCIATION 1004 DUKE STREET, ALEXANDRIA, VA 22314-3512
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most popular dramas in English literature, The Merchant of Venice, deals with the peculiarities, eccentricities, and even the dangers of suretyship. However, if everyone had listened to the advice of Shakespeare when he said, "Grant I may never prove so fond, to trust man on his oath or bond," the construction industry as we know it would not exist.

Today, bonds are required by the Federal Government under the Miller Act and by state and many local governments under a myriad of "little Miller Acts". There are growing trends for private owners to require bonds from their general contractors, and general contractors to require bonds from their subcontractors. Both trends have been fanned by marketing campaigns sponsored by The Surety Association of America and the National Association of Surety Bond Producers.

So, if as Cervantes has Don Quixote say, "an honest man's word is as good as his bond," a contractor's word carries the value of a three dollar bill unless it is accompanied by some acceptable surety company's product. In essence, bonding capacity is a literal life or death matter for any construction firm wishing to move beyond very small projects.

But at a time of growing demand for bonds, there is a reduced capacity in the market to provide such bonds because of monumental losses suffered by surety companies in recent years. For example, according to The Surety Association of America, surety losses during 1986 totaled $1.1 billion--that is, sureties paid out $1.63 for every $1.00 earned. This problem was discussed thoroughly in an article entitled "Bonding, Insurance Falling Short," which appeared in the March 31, 1988, issue of the ENR, a McGraw-Hill weekly magazine covering the construction industry (See Attachment A).

Getting a Bond

Though there are many types of bonds, there are generally three basic contract bonds common in the construction industry: bid bonds, performance bonds, and payment bonds.

(1) A **bid bond** serves as the basic "prequalifier" on many projects. To obtain a bid bond, a contractor must prove to a surety company that his firm has the ability to enter into a contract if one is offered and that he can qualify for whatever additional contract bonds may be necessary to fulfill the contract terms.

(2) A **performance bond** warrants that the contractor will build that which he has contracted to build and will build it according to the contract's plans and specifications.

(3) The **payment bond** assures subcontractors and suppliers are paid, subject to any limitations spelled out by contract or by law.

A surety then is concerned with guaranteeing a contractor's performance and the payment of debts. Before providing that guarantee, a surety thoroughly investigates the prospective principal to assure that the contractor has the ability to satisfactorily perform the obligation being bonded. The information sought by the surety is commonly called the three "C's"--capacity, capital, and character.

Capacity is the contractor's ability to do the work. The surety wants to be sure that the contractor has the ability to manage as well as build. To determine if a contractor can handle the project in question, the surety will delve deeply into a myriad of internal functions, including the education and experience of the key managers of the contracting firm, the track record of the firm itself, trade references, and the firm's business plan.

The second "C" is **capital**. It takes money to start a job, to finance retainage, to pay overhead, to prepay bills, to finance slow receivables, and to insure the availability of bank credit. The amount of money needed can depend on the type of work being performed or the company performing it.

The third "C" is **character**. The surety will almost always ask the contractor, particularly a small business contractor, to provide the personal indemnity of the stockholders of the company and probably that of their spouses as well. This is sometimes a sensitive area. But the willingness of a contractor to stand behind his company and support it with his personal assets is a very important consideration of a surety. In a sense, the surety asks the contractor to put his money where his mouth is.

Additional details on suretyship and how a surety evaluates a contractor are contained in Bonding for Subcontractors, a manual published jointly by ASA and the National Association of Surety Bond Producers (See Attachment B).

Bonding and Small Businesses

The construction industry is an industry that is renowned for the ease of entry by new businesses. It is an an industry in which the rate of small business participation outpaces that of almost every other industry. The construction industry is, in short, an industry dominated by small businesses.

This could all change if the trends of increased demand for bonds and a reduced capacity continue without some kind of concerted effort to make bonding available for qualified small businesses. Already, all too frequently, small businesses find it difficult, if not impossible to obtain the bonding necessary to assure their survival and growth.

Apparently, most sureties have concluded that small contractors are qualitatively a riskier proposition than large contractors. At the same time, it is nearly as expensive to investigate and "prequalify" a small contractor as a large contractor.

As a result, some sureties have set minimum experience requirements or minimum years in business requirements. Others have set up minimum financial limits involving minimum net worth or working capital. The underlying rationale for these minimum financial requirements appears to be that the lack of a financial cushion leaves a contractor unable to sustain itself in the event of an impairment of its cash flow, a significant loss on a job, or a long period without work where existing capital is consumed by overhead.

Whatever the rationale of the surety companies, small business contracting firms, which historically have had problems obtaining adequate bonding, will, in the future, have even more serious problems.

The SBA Surety Bond Guarantee Program

One of the lifelines for small business construction firms attempting to obtain adequate bonding in order to survive and grow has been the Small Business Administration's Surety Bond Guarantee Program. Authorized by Congress in 1971, the SBG Program permits SBA to guarantee a surety company that it will be reimbursed up to 90 percent of any bond written for a small business within stated limits and guidelines. Currently, SBA provides an 80 percent guarantee on bonds written for contracts under $1.25 million for contractors with an annual volume of less than $3.5 million.

The SBG Program was designed primarily to help the small business contractor who cannot meet the minimum experience requirements, the minimum years in business requirements, or the minimum net worth or working capital requirements--but which otherwise appears to be able to satisfactorily complete the project for which the bond is provided.

S.2259, the Preferred Surety Bond Guarantee Program Act of 1988

S.2259, the Preferred Surety Bond Guarantee Program Act of 1988, would make important improvements to the SBG Program--improvement that could increase the ability of the SBG Program to provide bonds to small businesses.

S.2259 is designed to encourage the participation of the so-called standard surety companies in the SBG Program. It does so by reducing the involvement of SBA in the day-to-day approval of bonds. At the same time, S.2259 reduces the guarantee to firms participating in the pilot program to 70 percent. If sufficiently used, this reduction in the guarantee could allow SBA to write a greater number of bonds under the existing $1.25 billion of guarantee authority.

S.2259 also would clarify that the SBG Program's guarantee authority is a revolving fund. The bill provides that as soon as SBA receives a notice of release from the participating surety, the guarantee funds again become available for bonding. This, too, will allow SBA to increase the number of bonds it provides under the SBG Program.

ASA supports S.2259 as a step toward addressing the problem of increased demand for bonds coupled with reduced capacity. ASA urges this Committee also to address the capacity problem by increasing the amount of SBA's guarantee authority from the current $1.25 billion to $1.75 billion. This will allow increased participation in the SBG Program by small business firms, which are being driven out of the regular surety market.

Summary

The ability to obtain surety bonds is a prerequisite for survival and growth of a construction contractor. Small business construction firms historically have had a difficult time obtaining adequate bonding. The convergence of two trends--an increased use of bonds and a reduced capacity in the surety market--is further restricting the ability of small business construction firms to obtain adequate bonding.

One lifeline for the small business construction firm has been the Small Business Administration's Surety Bond Guarantee Program. S.2259, the "Preferred Surety Bond Guarantee Program Act of 1988", would make important improvements to the SBG Program by increasing the ability of the Program to provide bonds to small business.

The American Subcontractors Association strongly supports this S.2259 and urges that it be further amended by increasing the amount of SBA's guarantee authority from the current $1.25 billion to $1.75 billion.

Attachment A

ENR COVER STORY

INSURANCE

Bonding, insurance falling short

But contractors, designers are bouncing back with some new ways of doing

Bonding and insurance have long formed the net that keeps owners, contractors, designers and the rest of the construction team from falling into an abyss of financial ruin caused by negligence, cash flow problems or accidents. At the moment, the net is too small because of monumental losses suffered by sureties and insurers in construction. As a result, more and more companies are going bare, calling it quits, seeking white-knight purchasers or avoiding certain markets they would otherwise love to be in. But even as that is happening, the industry is developing some new protections for itself.

Bonding is the most immediate concern for many contractors. Sometimes described as the "lifeblood" of a construction firm, it has been drying up for many since 1986 as sureties have tightened up their underwriting to stanch the flow of red ink. "In the last two years, [sureties] lost all of the profit they ever made" in construction, says Kenneth N. Ryan, executive vice president of Corroon & Black Insurance Services, Pasadena, Calif.

Most sureties don't dispute that startling allegation, although one claims that it was only the profit of the last 20 years that was lost. According to the Surety Association of America, 1986 was the worst year ever for sureties, with total losses hitting $1.1 billion. "For every dollar earned, [they] paid out $1.63" in claims, says Vice President Dennis E. Wine.

SAA has not yet completed its annual survey of sureties for 1987 results, but preliminary data indicate that it "is going to be a little better than 1986 ... but not enough for a profit," says Wine. While he notes that "not everyone is swimming in a sea of red ink," some sureties have curtailed their activities in construction and "in a few extreme cases dropped out." For the most part, however, "the major writers have stayed and rededicated their efforts to sound underwriting," he says.

Many contractors are in for trouble, says Bruce T. Wallace, executive vice president of the National Association of Surety Bond Producers. There is "a lot of excess [construction] capacity out there that has to be weeded out," he claims. "Reputable sureties are doing their best to weed out the non-players."

Most of the bonds that caused the losses in 1986 and 1987 were written several years before. In addition to the effects of the recession of the early 1980s on the industry, sureties themselves are partly to blame. They say that "cash-flow underwriting" was common in many firms. The companies wrote bonds without much regard to the risks and counted on revenues from invested premiums. Some say the government also is to blame "with the up and down way" it has run construction programs, particularly for highways.

"Contractors get geared up to go

and two years later there is no money," observes Wine.

The result is "diminished capacity" to write the payment and performance bonds required on federal projects under the Miller Act, as well as state and local public works jobs and a growing number of private projects. Solid contractors can still obtain the bonds they need with "minimum effort," while less desirable firms find it "difficult or near impossible," says Wine. It's like dating, he explains. "The pretty girls have six guys on their doorstep.... My advice is to get prettied up."

According to sureties, some of the blemishes that may cause a contractor to be passed up include too much work, a reputation for being a slow payer, a move into another construction specialty or another state, a track record of little or no profitability, problem jobs under way, or disputes with the Internal Revenue Service.

Unforgiving. Sureties say they "are very unforgiving" about character-related items such as an earlier bankruptcy filing or a bid-rigging conviction. Asbestos abatement contractors and hazardous-waste cleanup contractors face very, very careful scrutiny by sureties. Some say they even redline the categories because of potential risks.

The retrenchment and reexamination of the construction market by sureties and reinsurers has caused a lot of pain and shotgun marriages. "Some companies have been totally cut off for nothing that should have excited [the sureties] much," claims Denton R. Hammond, national construction industry director for Grant Thornton, an accounting and consulting firm.

"We have gotten a slug of phone calls from people whose [bonding] has been eliminated and who needed a joint venture partner," adds Hugh L. Rice, senior vice president of the Fails Management Institute, Denver. "This has been driving acquisition activity the way the open shop [movement did] in the 1970s." Rice claims that foreign firms are stepping foward in some cases because not that many U.S. firms have excess bonding capacity.

Bondability is a precious commodity because it affects the capacity of construction firms to do work. More companies are protecting it, even by filing lawsuits for damages if their bonding is affected by project delays. One recent New York case involved Hirsch Electric Co., which sued Community Services Inc. because delays on a school project limited its bonding capacity and prevented it from bidding on another project. The appellate division of the New York State Supreme Court ruled, however, that the $800,000 in lost profits Hirsch claimed was "based on inferences piled on inferences" and was "too speculative to give rise to recovery for lost profits."

According to Hammond, the unavailability of bonding will "very dramatically affect the economics of the industry over the next 12 to 18 months." Contractors with bonding problems will have to obtain guarantees from other firms, find joint ventures or turn to "self-surety" schemes.

A wild card that also will affect the ability of contractors to obtain bonding is the erosion of working capital caused by restrictions the new tax law places on the use of the completed-contract method of accounting. "Some contractors literally have to take out a line of credit to pay current taxes," says Hammond. "The sureties are going to have a tough time with that."

No embrace. The self-surety or personal-surety alternative is not one that is being eagerly embraced by the sureties or contractors. Federal law requires that sureties providing bonds on federally funded projects be on a list approved by the Treasury Dept. But the Miller Act also allows contractors to pledge certain assets, such as real property, to support a bond.

Personal sureties "are now terribly abused" and are being used on "very sizable contracts" says Wallace. Industry sources say the main problem is that the assets are generally out-of-state and may have been pledged several times over. The issue will be taken up soon in House hearings on a bill to amend the Miller Act and in Senate hearings on the reauthorization of the Office of Federal Procurement Policy. "The Miller Act does not specify the type of bond" required on federal projects, says E. Colette Nelson, director of government relations for the American Subcontractors Association. "ASA's position is that it should only be Treasury-approved bonds."

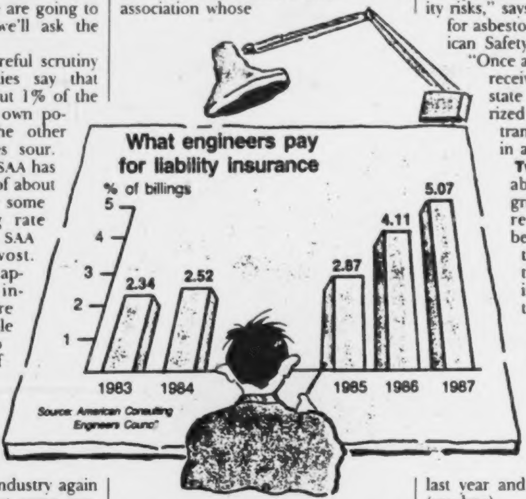
Help. There is help for small firms in the Small Business Administration's Surety Bond Guarantee Program. Under this program, SBA will guarantee the bonds of small contractors that cannot obtain bonds in the commercial market. Surety agents "will set a contractor up with a surety and get a regular bond," says claims manager Brian Yoklavich. "They may not even know that it is SBA-guaranteed." If there is a claim, the agent will settle it and be paid 80% of the loss.

Congress authorized the program to guarantee up to $1 billion worth of bonds a year. But this was not enough in fiscal 1986, when SBA ran out of authorization. Starting last year, the guarantee was reduced to 80% from 90% of the bond and the agency "barely" made it through, says Yoklavich. SBA will guarantee bonds only for firms with average annual revenues under $3.5 million working on projects worth less than $1.25 million—no matter what the size of the bond. Most claims are caused by underbidding, notes Yoklavich.

Sureties, agents and contractors with good bonding relationships claim that companies have to change the image they portray to sureties. "You have to look like a contractor," says Corroon & Black's Ryan. "No more orange groves, nut farms... and restaurants, [and] you have to make money in this business." Contractors also have to work with their sureties. "You need them," Ryan told mechanical contractors recently. "You are going to have to start educating them about your business."

"We really do" work on contractor relationships, notes Michael C. Peters, director of contract surety for Safeco Insurance Co. of America, Seattle. He says Safeco writes bonds the old-fashioned way and has made a profit the last 28 consecutive quarters because of it. "We visit the account, meet with them and find out what they need," says Peters. "Financials are just one ingredient" in the decision-making process, he adds. Safeco and almost all other sureties now require company owners to pledge personal assets against the bonds. "If we are going to support the company, we'll ask the owners to," says Peters.

The reason for the careful scrutiny is risk exposure. Sureties say that bonds generally cost about 1% of the face amount, with their own potential liability being the other 99% if the project goes sour. But prices are going up. SAA has filed for a price increase of about 20% in each state, while some companies are seeking rate hikes on their own, says SAA President Lloyd Provost. About 35 states have approved them. "The increases are weighed more heavily on the lower scale to encourage firms to open up their writing of smaller contractors," he explains. "I think we will also see more reinsurers coming in."



Source: American Consulting Engineers Council

Warming up. Insurers and reinsurers are also warming up to the industry again for liability insurance. But some specialty coverage can be had only at a steep price, if at all. These include professional liability insurance for architects and engineers and insurance for firms performing asbestos and hazardous-waste work.

But the insurance crisis of the past several years, which saw some company premiums skyrocketing for shrinking coverage, may not have been solely the product of market forces, claim attorneys general in eight states. Last week, seven filed class-action antitrust suits in the federal district court in San Francisco against four U.S. insurance companies, the two principal U.S. insurance trade associations, some British companies affiliated with Lloyd's of London, and various other parties. They claimed that the 31 defendants conspired to manipulate the U.S. market for commercial liability insurance.

"The liability-insurance crisis is not entirely the result of cycles in the financial markets or the emergence of new and expensive risks," says New York State Attorney General Robert Abrams. "It is to a substantial degree the result of deliberate and illegal actions taken by the most powerful actors in the business. International conspiracies resulted in policies so shrunken in scope, so reduced in value to the consumer, they can hardly be described as insurance at all."

The complaint focuses on alleged manipulations of the standard policy forms for commercial general liability (CGL) insurance produced by Insurance Services Offices, a trade association whose forms are the model followed by virtually all U.S. insurance companies. "Anticonsumer revisions were made in the ISO CGL forms as a result of boycotts, threats, intimidation and other coercive conduct by the defendants," say the court papers. "Insurance coverage for pollution claims was completely eliminated from the ISO CGL policy forms [and] insurance coverage for prior events was also eliminated from the new ISO CGL claims-made insurance form." The states claim that the result of this action was a "severe market-wide constriction" of liability insurance coverage.

Among others, the suit names as defendants ISO, the Hartford Fire Insurance Co., Allstate Insurance Co., Aetna Casualty and Surety Co., CIGNA Corp., and Reinsurance Association of America. The states suing in federal court are New York, Alabama, California, Minnesota, Massachusetts, West Virginia and Wisconsin. Texas filed a related suit in state court.

The inability of architects and engineers and some contractors to obtain adequate liability insurance and its rising cost are prompting some innovative alternatives, many of them developed under the federal Risk Retention Act of 1986. The act allows shareholders to pool their risks and either purchase insurance or form a self-insurance program. The latter, a risk-retention group, can be chartered under the laws of any state "for the purpose of assuming and spreading all or a portion of group members' liability risks," says one new group formed for asbestos contractors—the American Safety Risk Retention Group. "Once a risk-retention group has received its license from its state of domicile, [it] is authorized to solicit members and transact insurance business in all other 49 states."

Two approaches. So far, about 200 purchasing groups and nearly 50 risk-retention groups have been formed in all industries. The difference between the two approaches is illustrated in the operation of a risk-purchasing group for structural engineers administered by insurer DPIC Cos., Monterey, Calif., and a risk-retention group called Architects & Engineers Insurance Co., Northbrook, Ill., which started operations late last year and is licensed in Delaware (see box).

The purchasing group, Structural Engineers Risk Management Council, was formed late last year to address the severe problems that structural engineers are having in the professional liability insurance market. According to the American Consulting Engineers Council, structural engineers paid more than 9.3% of billings for such insurance last year, almost double the 5% paid by other consulting engineers (see chart).

"The severity of the claims has increased, not so much the frequency," and that is the result of "the nature of the work" and the "complexity," says A. Russell Chaney, DPIC's senior vice president for program management. With rates going through the roof, "the structurals came to us, put the gauntlet down and said 'you have to do something,' ," he adds.

Under the plan, participating firms buy professional liability policies from DPIC, but they recoup as a group the amount not paid out in claims after DPIC takes 30% for administrative costs. All members of the group, which now numbers 125 firms, are scrutinized for loss prevention through a "technical practice review" paid for by DPIC. In it, a licensed professional engineer looks at the firm's practices and makes a spot check of documents. Chaney says DPIC is currently working with ACEC's structural engineering coalition—CASE—to use its peer reviewers plus "our unique package."

The structural engineers also "have a voice in the program," says Chaney. He claims that about 500 more firms have expressed an interest in the plan.

"On balance, our commitment has been to maintain rates at an even level," says Chaney. Company premiums are set individually, depending on location and other factors. "We think we can do it with other disciplines," but we want to refine the program first, he adds. He claims that the main advantage of a purchasing group is that it "uses the power of the group" to buy insurance and improve loss prevention, while a risk-retention group gets A-Es into the insurance business and retains "a high degree of risk."

Changes. Even though the liability insurance market for contractors and designers has been softening over the past year, some say that it will never be the same. Rates are not likely to decline to pre-1985 levels, and the insurance industry may have lost business permanently to the purchasing groups, retention groups, captive insurance companies and risks no longer insured because of self-insurance, lower policy limits or higher deductibles.

"Certainly, many in the construction industry looked at these options and evaluated them," says Robert Wenneson, corporate risk manager for Omni Construction Inc., Bethesda, Md. "Many firms saw increases as high as 1,000% in one year," he adds.

But quantifying the loss to insurers may be difficult. "How the industry reacted to the insurance crisis individually is proprietary information," says Wenneson. While he will not disclose his firm's response, he notes, "Once firms have taken on the responsibility of acting as insurers, there is a great deal of administrative activity" invested that will not be junked just because premiums ease a little. Nonetheless, he says, the issue remains, "Do I really want to keep the risk?" ■

By William G. Krizan

A-Es taking a dip into risk-sharing

Harold A. Dombeck, executive vice president of Melville, N.Y.-based H2M Group, decided to jump into a risk-sharing pool with other design firms because the sea of problems in the professional liability insurance market threatened to drown his civil and environmental engineering firm.

"Over the last four years we've seen our premiums quadruple, we've reduced our coverage by half, and we've taken the deductible up five times higher," explains Dombeck, who is also chairman of Architects and Engineers Insurance Co. Dombeck says H2M's former insurance carrier also "emasculated part of the policy by taking away professional liability coverage for pollution and asbestos materials, yet they continued to rate the policy based upon our entire gross income."

But things are different in AEIC, Dombeck explains, because it "is owned only by architects and engineers" and all participants have a vested interest in the success of the enterprise. "Every firm that joins must become a shareholder," he says.

Although AEIC touts itself as the industry's first risk-retention group for A-Es, Dombeck says it is actually a combination risk-retention and risk-purchasing group. Under the AEIC format, Cleveland-based Progressive Casualty Co. is the primary insurer and AEIC will reinsure Progressive. "We take a portion of the risk," says C. Roy Vince, an insurance consultant who helped set up AEIC.

The Progressive-AEIC program can write up to $5 million in professional liability insurance for each member firm. "We can take a $5-million layer of protection and fit it anywhere in a company's insurance program," says Vince. The program is also linked up with Union American Insurance Co. of London, which will provide AEIC shareholders with another $5 million worth of coverage on a case-by-case basis.

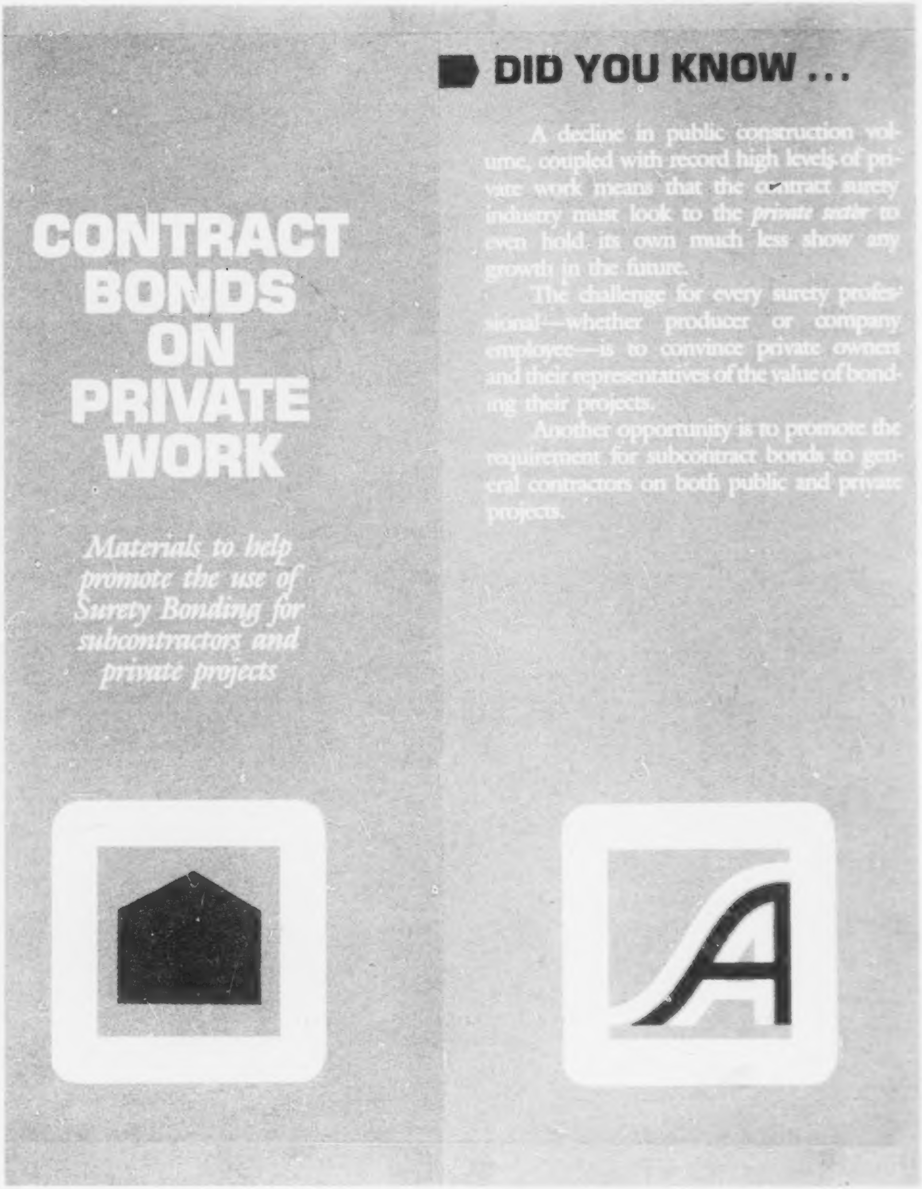
By splitting the risks, AEIC enjoys collective buying power in dealing with Progressive and the potential profits of retaining risks, says Dombeck. "We take back 50% of the risk on the first $3 million of coverage. Because we take on 50% of the risk, we also get 50% of the premium," he adds. Dombeck notes that a risk-purchasing group shares in the profits only if the insurance company allows it to.

AEIC also limits the maximum losses that Progressive may suffer on claims to 125% of premiums, and Progressive has therefore agreed to limit its profits to 4% of premiums, says Dombeck.

AEIC currently has nine active policies and commitments from two other companies to join the program soon. More than 1,800 have expressed an interest. "Only firms that meet the most rigid standards will be accepted into the program," says Jack R. Janney, the retired CEO of Wiss, Janney, Elstner Associates, Northbrook, Ill., who advises AEIC on qualification requirements. Of the 38 design firms that have gone through the rigorous prequalification process, 33 have passed and five have flunked.

After companies have become AEIC shareholders, they are audited at least once a year and must implement loss prevention recommendations. "To avoid abnormal losses, it's important to maintain the quality of the restricted pool," says Vince.

By Jeffrey Trewhitt in Chicago



CONTRACT BONDS ON PRIVATE WORK

Materials to help promote the use of Surety Bonding for subcontractors and private projects

DID YOU KNOW . . .

A decline in public construction volume, coupled with record high levels of private work means that the contract surety industry must look to the *private sector* to even hold its own much less show any growth in the future.

The challenge for every surety professional—whether producer or company employee—is to convince private owners and their representatives of the value of bonding their projects.

Another opportunity is to promote the requirement for subcontract bonds to general contractors on both public and private projects.

TO ASSURE A SUCCESSFUL PRESENTATION . . .

The When You Build, Should You Bond? program includes:

- 80-35mm color slides arranged in a universal carousel slide tray with a slide-sync and cued cassette soundtrack; or a ½ inch VHS video cassette.
- Printed program script.

In addition, you will want these publications to hand-out to your audience or to use in direct mail promotions:

- *When You Build, Should You Bond?* In question/answer format, this ten-page pamphlet shows how surety bonds provide the owner with protection against loss as well as the benefit of a surety's thorough prequalification review of the contractor. One copy comes with the slide show or video show. Additional copies are available *at no charge* to SAA and NASBP members.
- *Protect Your Construction Lending with a Surety Bond.* Directed towards the construction/real-estate lender, this brochure explains the bonding process and how a surety bond offers investment protection. No charge for NASBP and SAA members.
- *Contract Bonds—*
  The Unseen Services of a Surety.
  75 actual cases are described showing surety intervention to avoid default or complete the contract. 61 pages, $1.00 per copy.

TOOLS TO HELP . . .

To help you in this important job, the National Association of Surety Bond Producers and the Surety Association of America have produced an audio-visual program, *When You Build, Should You Bond?* This informative 14-minute program persuasively makes the case for bonding private projects and explains the advantages of surety bonds for the owner, lender, attorney, architect and engineer, risk manager and the contractor himself.

The presentation effectively outlines the inherent risk of contracting, and shows the most frequent causes of contractor failure. Three case studies are profiled to demonstrate how a surety responds when a contractor is in trouble on a job.

The program is available in a VHS video cassette format or 35mm slides with cassette soundtrack.

NASBP

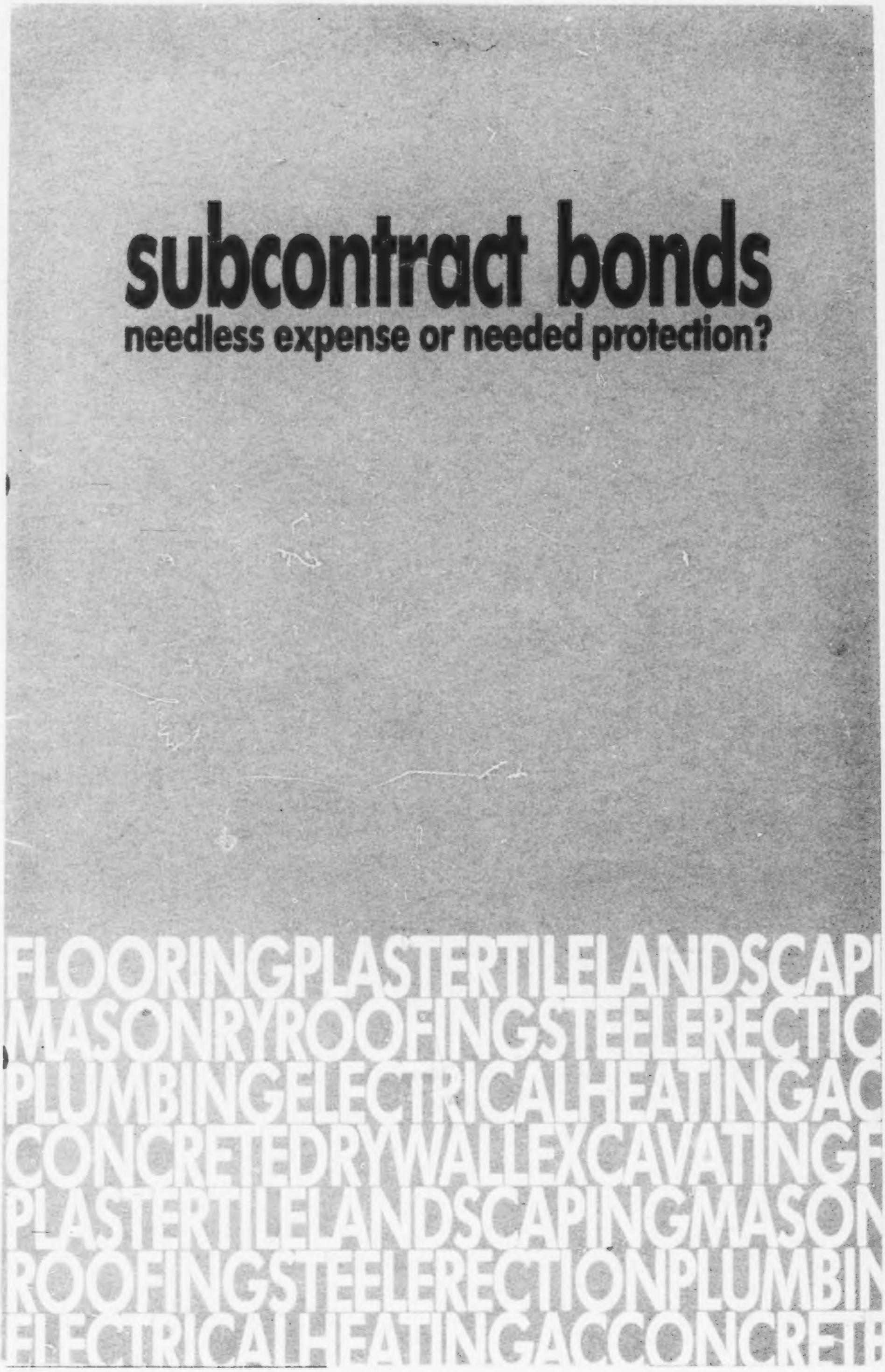
- *Surety Companies: What They Are and How to Find Out About Them.* Tells public and private obligees where to find information on surety companies—their financial status and reputation in the marketplace. No charge to NASBP and SAA members.
- *Subcontract Bonds— Needless Expense or Needed Protection.* Explains to general contractors how a surety's prequalification and risk transfer make the requirement for subcontract bonds a wise business decision. $1.00 each for 1 to 24 copies; over 25, 75¢ each.

ORDER TODAY . . .

Use these valuable promotion tools with project owners, bankers, attorneys, architects and contractors to show the value of corporate suretyship. Show the audio-visual program and develop direct mail campaigns to targeted groups in your area. Arrange for presentations at Rotary, Kiwanis, your church group—spread the word about bonding, and reap the benefits for your agency or company, and the entire surety industry.

Mail the attached order form today!

ORDER FORM



subcontract bonds

needless expense or needed protection?

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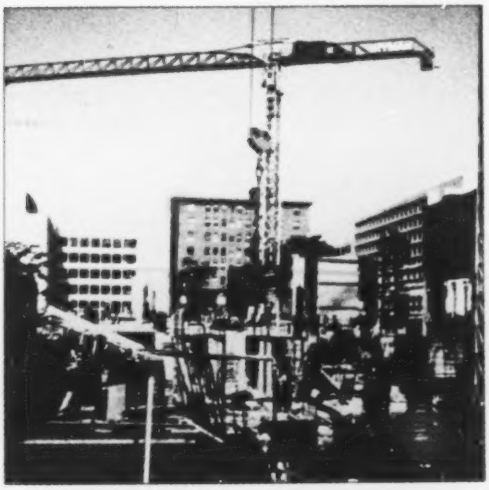


subcontract bonds

The bonding of major subcontractors and suppliers is becoming a common practice in the construction industry. While surety companies may at times require their prime contractor clients to bond their subs, prime contractors are more often seeing subcontract bonding as simply a prudent business practice.

Requiring performance and payment bonds from subcontractors on a project where the owner has required bonds of the prime contractor is often erroneously referred to as “double bonding”. This is clearly a misnomer: the bonds that the prime contractor provides to the owner are for the *owner's protection only.* They shield the owner from the consequences of the default of the prime contractor, but offer the prime contractor no protection from subcontractor or supplier default.

Prime contractors require bonds of their major subcontractors and suppliers for the same reasons that owners require bonds of prime contractors: to avail themselves of the prequalification services of a surety and to transfer the risks of subcontractor or supplier failure. Without a subcontract bond, the prime contractor in effect must itself act as surety for the subcontractor.

We'll examine the advantages of subcontract bonding in detail.

prequalification

Prime contractors who obtain bonds from qualified surety companies are well aware of the extensive prequalification process performed by the surety underwriter before bonds are issued. A subcontractor's or supplier's surety will engage in a similarly thorough review of the firm's finances, previous experience and capacity to perform the subcontract before issuing bonds.

Many prime contractors do not have the trained staff, nor do they want to spend the money and devote the time necessary to complete the extensive credit analysis, financial statement review, and analysis of current workload required to prequalify their subcontractors.

Even in cases where the prime contractor knows the sub, has used him on other projects, and perhaps even receives the endorsement of the sub's banker, requiring subcontract bonds is the prudent course. Keep in mind that a sub's good reputation will not necessarily indicate the firm's ability to pay bills at some future time.

WHY PREQUALIFY SUBCONTRACTORS?

- How can the contractor be sure that the sub who has performed well in the past hasn't more work on hand than it can handle?
- Or, that the subcontractor has not weakened the company with unwise withdrawals or investments?
- And how can the prime contractor be certain that a previously reliable subcontractor does not have a bad job with some other prime contractor that is threatening the firm?
- Or, perhaps it's a good job but with a prime contractor who is in trouble and is not paying the subcontractor, creating serious cash flow problems.

- Does the subcontractor have adequate insurance coverage to protect his operation from financial ruin in the event of disability or death?

Would the prime contractor's "in-house" prequalification process uncover these situations? Generally, a surety has a close, long-standing, personal relationship with the subcontractor, its employees, attorney, banker, accountant and other advisors. Because of this, the surety has access to detailed financial information, ongoing analyses of organizational strengths and weaknesses and information on current problems facing the subcontractor. Most of this information would be unavailable to the prime contractor. Therefore, because of the depth of knowledge of the subcontractor client, the surety is in a much better position to make a solid and informed decision on whether the subcontractor is qualified to do a particular job.

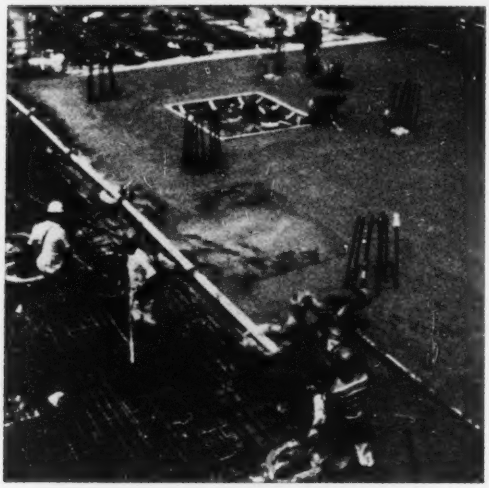
Remember, it is unlikely that a subcontractor would tell a prime about the problems the firm might be having for fear of losing the subcontract.

Prime contractors will find that the cost of the subcontract bond is a small price to pay for this extensive prequalification service.

case:

GC WAIVES BOND, PAYS $90,000

A Prime contractor had been in the practice of bonding subcontractors, but decided to waive bonds on a mechanical sub whose past performance on jobs where subcontract bonds were required was deemed to be satisfactory. Deciding that his past experience was prequalification enough, the prime contractor felt the expense of a subcontract bond was not justified. During the course of the project, however, the mechanical sub used his progress payments from the prime contractor to finance other business ventures as well as numerous trips to Las Vegas rather than pay his suppliers. The suppliers filed over $100,000 in liens against the project. To date, the prime contractor has paid out nearly $90,000 to satisfy the liens–costs which would have been paid by a surety had the mechanical sub been bonded.



risk transfer

When a contractor signs a construction contract, he is representing to the project owner that the job will be completed and all bills paid. He is making this promise for his own firm and for all of the subcontractors on the project.

Most contractors utilize various techniques to monitor and control their subcontractors' performance, including the withholding of retainage and the use of payment affidavits. The contractor may even have an "in-house" prequalification procedure.

While these techniques are all useful, they do not alter the fact that the prime contractor ultimately bears the risk of subcontractor failure. Subcontract payment affidavits, for example, will not protect the prime contractor when a supplier or sub-subcontractor can demonstrate he has not been paid. The prime contractor may well find himself in a position of paying a second time for supplies or labor.

Withholding excessive retainage from a subcontractor can seriously affect the firms's cash flow. For most small contractors, adequate cash flow is vital to its ability to perform, and it should not be needlessly impaired.

Many subcontracting firms are closely-held companies which are totally dependent on a single individual for their survival. What happens if this person becomes disabled or dies in the middle of performing several subcontracts. Subcontract bonds would protect prime contractors from this risk.

A prime contractor who requires performance and payment bonds from his major subcontractors and suppliers transfers the risk of subcontractor/supplier failure to perform and pay bills to the surety company. This "risk" is considerable, especially when completion of the prime contract depends upon the timely delivery by suppliers of key equipment or materials, or when a subcontractor is doing a highly technical part of the project.

RISK OF SUBCONTRACTING

- **Non-payment of the subcontractor's suppliers and sub-subcontractors.**
- **Disability or death of principal of subcontracting firm.**
- **Disputes between sub and suppliers or sub-subs resulting in liens being filed.**

Another concern for the prime contractor, when doing private work, is the possibility of a lien being filed on the project because of a dispute between a subcontractor and one of his suppliers or sub-subcontractors. If the subcontractor has provided a performance and payment bond covering his subcontract he will be able to readily obtain a release of lien bond from his surety.

The difference in cost between an unbondable low bidding sub, and a second or third bidder who can provide a performance and payment bond could well turn out to be a small price to pay for the protection offered by the surety guarantee.

case:

SUB'S EMPLOYEES WALK OFF JOB

A large Southern California building contractor had established a policy of bonding all subcontracts over $50,000. In April 1984, they let a $55,000 subcontract for the fire sprinkler portion of a hospital parking structure. The actual work on the fire sprinklers was to start in March 1985. In November 1984, the sub went into bankruptcy proceedings. However, the work was started in March, and by June it was two-thirds complete. The president of the subcontracting company suddenly resigned, causing all employees to panic and walk off the job. The prime contractor then contacted the subcontractor's surety. Within three working days, the surety replaced the sub with a new contractor, who completed the sprinkler subcontract. The loss to the surety was $35,000

case:

SUB'S SURETY AND PRIME CONTRACTOR COLLABORATE

Suffering serious financial reversals, a small privately-held electrical subcontractor abandoned a subcontract on a publicly-owned project. The subcontractor's surety and the prime contractor established and agreed upon completion cost goals for unfinished work. The surety funded the extra cost of hiring another electrical subcontractor to complete the work in a manner compatible with the prime contractor's normal operation and with only nominal interruption of progress. At the same time, the prime contractor assisted the surety in reviewing the defunct subcontractor's vendor invoices to verify materials actually supplied to and incorporated into the project.

In the absence of the surety's participation, the entire cost of the subcontractor's failure would have been borne by the prime contractor.

personal indemnity

The owners of subcontracting firms are often required to personally indemnify the surety company against losses in order to obtain the desired surety credit. This means that if the surety advances its own funds to complete the subcontract or pay the subs' bills, they expect to be reimbursed by the owner or owners for the monies expended in their behalf.

The indemnity agreement assures that the principals of the subcontracting firm will stand fast in the face of problems and use their talents and best efforts to resolve difficulties. This willingness of a subcontractor to stand behind his company and support it with his own personal assets is very important to a surety.

And while the indemnity agreement is between the subcontractor and surety, its very existence should provide the prime contractor with additional confidence in the willingness of the sub to see to the completion of his contract, even in the event of difficulties.

The indemnity agreement confers an obligation on the *individuals* who are the principals and owners of the firm, whereas the subcontract is an agreement between the prime contractor and a possibly weak subcontracting corporation.

more surety credit for the general contractor

Bonding companies will take into account whether or not a prime contractor regularly requires bonds from subcontractors when considering increased surety credit for the prime contractor. Sureties recognize that subcontract bonds reduce the prime contractor's own risk exposure on a job.

A contractor may have difficulty convincing a surety to provide the needed surety credit when his workprogram is increasing at a faster rate than net worth. The bonding of major subs and suppliers may help to enhance the creditworthiness of the prime contractor by mitigating the risk of subcontractor failure through prequalification and the transfer of this risk from the prime contractor to the subcontractor and his surety.

a more cooperative subcontractor

Like all contractors, a subcontractor values his relationship with his surety. He will be interested in avoiding disputes with prime contractors because of the effect such disputes can have on the relationship with his surety. On many occasions, a subcontractor will avoid a confrontation with the prime contractor after "behind the scenes" consultation with his surety agent and company.

Further, the bond imposes on the subcontractor an added incentive to faithfully honor his subcontract. The bond binds the subcontractor more fully to the obligee of the bond—the prime contractor.

Contractors should accept subcontract bonds only from established, qualified surety companies which have a good record of handling cases of default. A contractor's own surety agent can advise him in this respect.

Contractors should also recognize that if a subcontractor's surety concludes that their client is correct in its position in a dispute with a prime contractor, the surety may take a hands off attitude in the matter.

subcontract bond costs

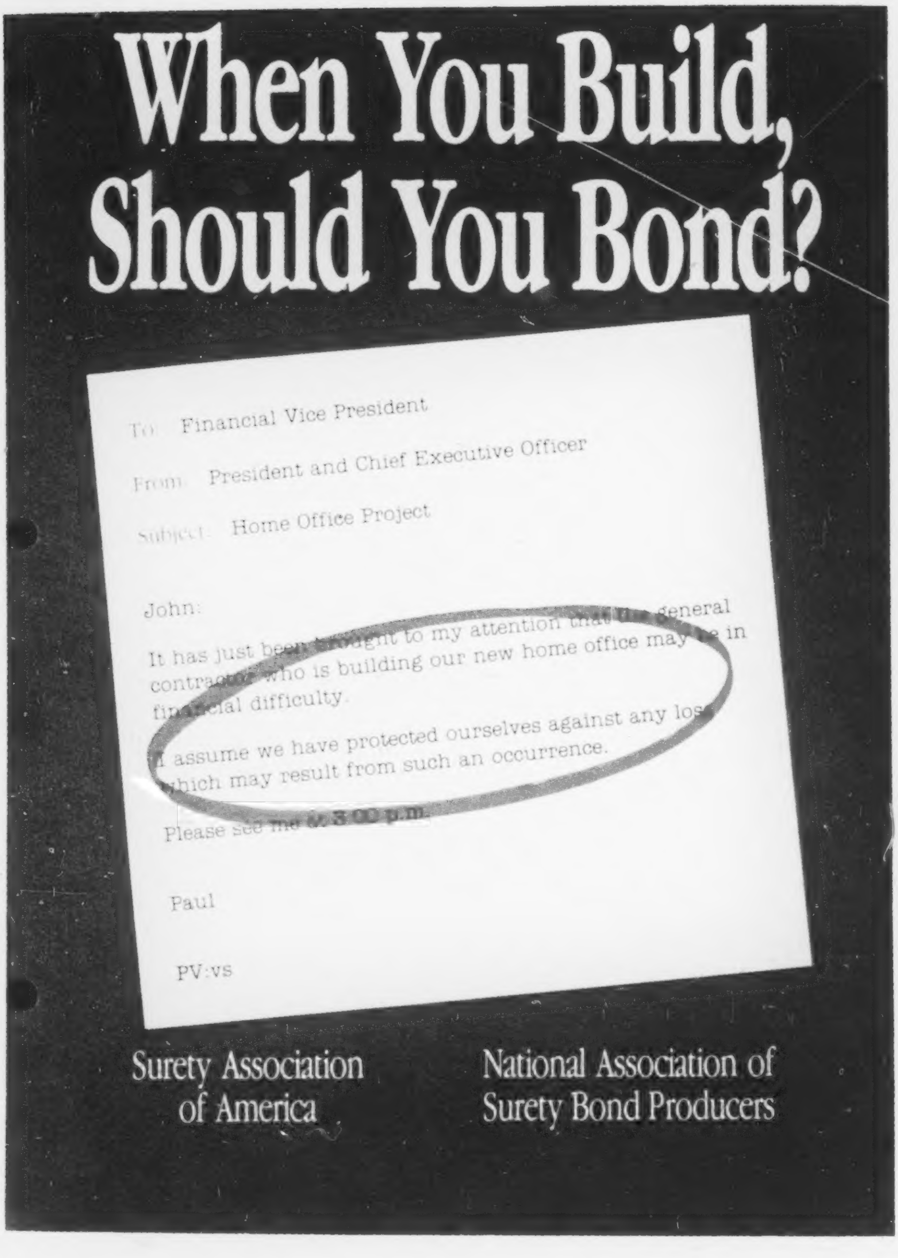
Rates for subcontract surety bonds vary but are generally 1.5 percent or less of the subcontract price for 24 months. The premium includes the cost of the performance bond, payment bond and one-year maintenance for defective material and workmanship. All rates are predicated on the subcontract price and type of work. The premium rate decreases as the subcontract size increases and for very large subcontracts can be less than ½ of one percent. Surety bonding is an excellent investment considering the actual percentage charge together with the long-term nature of the exposure.

Compared to the cost of other risk transfer contracts, such as builders' risk fire insurance, flood insurance, workers' compensation and automobile insurance, subcontract bonds are a bargain! Responsible prime contractors would not permit a subcontractor on a project without workers' comp., general liability, and similar risk-transfer contracts. It makes good sense to round out the protection offered by these insurance coverages with the performance and payment guarantees provided by subcontract surety bonds.

Prime contractors will often award a job to a subcontractor who is not the low bidder because they may have felt that a higher bidder was more reliable or financially more sound. Requiring bonds of bidders will allow you to safely accept the low bid, knowing that you are protected from the risk of the low bidder failing.

SUBCONTRACT BONDS: NEEDED PROTECTION

- **Prequalifies your subcontractors before they sign a subcontract.**
- **Transfers the risk of subcontractor failure to the surety.**
- **Through indemnity agreements, assures that owners of subcontracting firm will support company with personal assets if necessary.**
- **Improves contractor's credit standing with his own surety.**
- **A more cooperative subcontractor.**



When You Build, Should You Bond?

To: Financial Vice President

From: President and Chief Executive Officer

Subject: Home Office Project

John:

It has just been brought to my attention that the general contractor who is building our new home office may be in financial difficulty.

I assume we have protected ourselves against any loss which may result from such an occurrence.

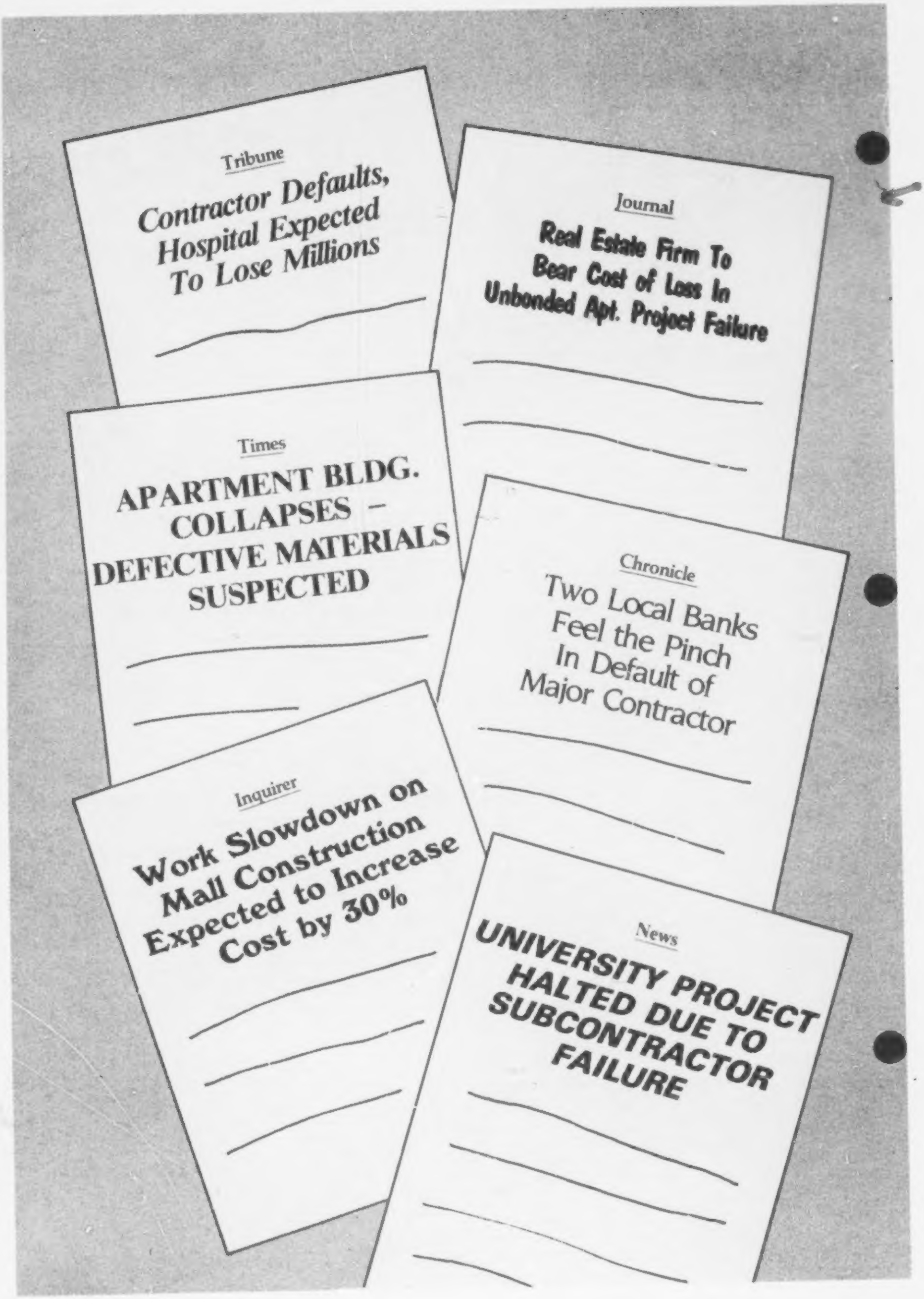
Please see me at 3:00 p.m.

Paul

PV:vs

Surety Association
of America

National Association of
Surety Bond Producers



Tribune

Contractor Defaults, Hospital Expected To Lose Millions

Journal

Real Estate Firm To Bear Cost of Loss In Unbonded Apt. Project Failure

Times

APARTMENT BLDG. COLLAPSES – DEFECTIVE MATERIALS SUSPECTED

Chronicle

Two Local Banks Feel the Pinch In Default of Major Contractor

Inquirer

Work Slowdown on Mall Construction Expected to Increase Cost by 30%

News

UNIVERSITY PROJECT HALTED DUE TO SUBCONTRACTOR FAILURE

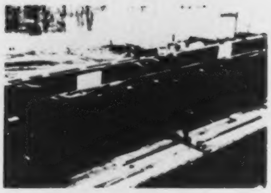
Introduction

Surety bonds have been used to guarantee the performance of contracts since the beginning of time. The Bible, the Magna Carta, and "The Merchant of Venice" all make reference to the use of suretyship to assure that someone will carry through on his or her promises. Since the late 19th century, surety bonds have been written in the United States by private corporations, and today they are an essential part of everyday business transactions. Performance and payment bonds are the catalyst that enables our existing open, competitive bidding system—mandatory for public construction—to function smoothly.

While surety bonds traditionally have been required in conjunction with public contracts, they are just as essential in private construction. When a company undertakes a building project, risk managers are expected to analyze all the perils that can result in a loss. Yet, in many instances, no attempt is made to protect against the failure of the contractor to perform. This can be far more costly than all other hazards combined.

This pamphlet is designed to acquaint private owners and their lenders, attorneys, architects and risk managers with the fundamentals of contract performance and payment bonds.

Using a question and answer format, it demonstrates how the requirement of surety bonds provides the owner with protection against loss as well as the benefit of a surety's thorough prequalification review of the contractor. In today's economic environment, anyone who plans to build, to provide funds for a building project, to design and oversee such a project, to provide legal advice for it or to analyze the risks such a project entails should consider requiring contract performance and payment bonds for protection. It is only prudent to do so.



1. Q. What is available to protect building project owners against financial loss resulting from the failure or default of a construction contractor?

A. Construction surety bonds.

2. Q. What are construction surety bonds?

A. A construction surety bond is a three-part instrument under which the surety joins with the contractor to guarantee to the owner that the contractor will comply with the terms and conditions of the contract. Generally there are three separate bonds. The first, the bid bond, guarantees that the bidder will actually enter into the contract at the price bid and provide the required performance and payment bonds. The performance bond protects the owner from financial loss caused by failure of the contractor to build the project in accordance with the terms and conditions of the contract. The payment bond guarantees that the contractor will pay all of the labor and material bills associated with the project.

3. Q. Who benefits from these bonds?

A. Construction surety bonds provide direct protection to owners of building projects as well as laborers, subcontractors and suppliers. At the same time, they either directly or indirectly benefit lenders, architects, engineers, attorneys and risk managers.

4. Q. How do they provide protection?

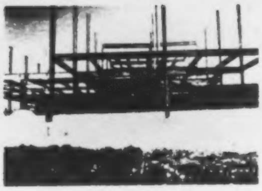
A. They provide protection in several ways:

1. For the owner, performance and payment bonds guarantee that the contractor will perform the contract and pay the labor and material bills incurred on the job. They also give the owner the additional security of knowing that the contractor has satisfied the surety's comprehensive prequalification review.

2. For the lender, the bonds provide assurance that if the contractor is paid, the project that secures the loan will be built in accordance with the terms of the contract.

3. For the architect or engineer, the bond provides confidence that, in the judgment of the surety, the contractor is capable of translating the plans into a finished product.

4. For the attorney, the bonds provide the security of



knowing that his client will be protected should the contractor fail to perform.

5. For the risk manager, the bonds provide the satisfaction of knowing that the owner is protected against one of the major perils of building, i.e., contractor failure.

5. Q. Who provides the bonds?

A. Surety bonds are provided by licensed surety companies which are willing to commit their assets in support of their contractor clients.

6. Q. How are surety companies able to offer this protection?

A. Surety companies possess requisite financial strength to provide credible guarantees to private owners or governmental bodies on construction projects. Since surety companies back up their guarantees with their own assets, they do not write bonds indiscriminately. Before surety companies approve a contractor bond, they will conduct an extensive prequalification review of the contractor.

7. Q. What is a prequalification review?

A. A thorough review of the contractor's finances, previous experience and capacity to perform the contract.

8. Q. If a private owner is currently prequalifying the contractor, why pay a surety to do the same thing?

A. An owner's prequalification process is likely to be more limited in scope than a surety's. Generally, a surety has a close, long-standing, personal relationship with the contractor, its employees, attorney, banker, accountant and other advisors. Because of this, the surety has access to detailed financial information, ongoing analyses of organizational strengths and weaknesses and information on current problems facing the contractor. Most of this information would be unavailable to an owner. Therefore, because of the depth of knowledge of the contractor client, the surety is in a much better position to make a solid and informed decision on whether the contractor is qualified to do a particular job.

To sum up, when an owner who doesn't require a bond makes a mistake in choosing a contractor, he is forced to bear the cost of it. In cases where the owner is protected by a construction surety bond, the surety will pay.

9. Q. Doesn't this close relationship sometimes cloud a surety's objectivity?

A. While this possibility exists, it must be remembered that a surety pays for its judgmental errors with its own money. This tends to maintain a surety's objectivity.

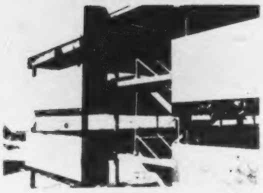
10. Q. What is the cost of contract surety bonds?

A. Rates for construction surety bonds vary but are generally one percent or less of the contract price for 24 months. The premium includes the cost of the bid bond, performance bond, payment bond and one-year maintenance for defective material and workmanship. All rates are predicated on the contract price. The premium rate decreases as the contract size increases and for very large contracts can be less than ½ of one percent. Surety bonding is an excellent investment considering the actual percentage charge together with the long-term nature of the exposure.

11. Q. Well, the price seems reasonable enough when compared to interest rates, but just what does an owner get besides a piece of paper?

A. The owner receives guarantees from a financially responsible surety company licensed to transact suretyship. Bonds perform the following functions:

1. Guarantee that the bonded project will be completed.
2. Guarantee that the laborers, suppliers and subcontractors will be paid even if the contractor defaults. This often results in lower prices and expedited deliveries.
3. Relieve the owner from the risk of financial loss arising from liens filed by unpaid laborers, suppliers and subcontractors.
4. Smooth the transition from construction to permanent financing by eliminating liens.
5. Reduce the possibility of a contractor diverting funds from the project.
6. Provide an intermediary—the surety—to whom the owner can air complaints and grievances.
7. Lower the cost of construction in some cases by facilitating the use of competitive bids.



12. Q. Are the services of the surety worth the price of the bond?

A. Certainly, that decision is up to you. However, in making this decision you should consider the savings that will result from bonding a project through the reduction or elimination of the following:

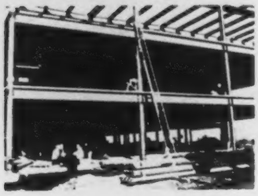
1. Staff time needed to prequalify contractors.
2. Staff time and administrative costs associated with processing requisitions and payment affidavits.
3. Costs added by subcontractors and suppliers to cover the possibility of not being paid.
4. Costs added by general contractors for administration of payment affidavits or lien rights procedures.
5. Cost to owner arising out of contractor defaults:
   a. Direct cost to owner because the contractor failed to complete the contract,
   b. Cost to owner of having to make good on a contractor's unpaid bills which can include tax liens.
6. Costs and complications to owner as a result of having to withhold money from the contractor as a means of imposing discipline or solving problems. These include:
   a. Disputes, arguments and slow-downs.
   b. Potential of contractor alleging owner's breach of contract.
   c. Undelivered materials.
   d. Ill will.
   e. Possible litigation.
7. Subcontractors and suppliers are likely to grant more favorable terms because their credit risk is eliminated. This has the effect of reducing the total cost of construction.

13. Q. What happens if liens are filed upon the bonded building project by laborers, materialmen or subcontractors?

A. The surety is obligated to arrange for the release of the liens. It may accomplish this in a variety of ways, but generally will provide separate bonds to release the liens.

14. Q. Can bonds be written only on projects which are let out for bid?

A. No. While one hears more about performance and payment bonds in connection with jobs that are bid, contract bonds provide the same protection to owners who negotiate their contracts.



15. Q. How can a lender directly benefit from a contract bond?

A. It's possible to name the lender as an additional obligee (beneficiary) of a contract bond. In such cases, surety companies will require a clause in the bond stating that the surety shall not be liable unless the owner and/or the lender makes all payments and performs all other obligations as provided in the contract.

16. Q. Are contractors going to object to a requirement for bid, performance and payment bonds?

A. Reputable contractors support the use of bonds as a legitimate part of the prequalification process. They recognize that bonding tends to screen out unqualified contractors and encourages fundamental fairness in bidding and award procedures. Furthermore, contractors are generally proud and protective of their ability to obtain bonds and of the bonding credit line extended to them by their sureties.

17. Q. How does a surety respond when a contractor is in default?

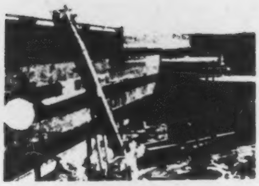
A. A surety has a variety of ways to respond depending upon the specific facts of the case. Each case requires individual treatment. The following representative claims illustrate the services a surety provides to an owner when a default occurs.

Case I

A performance and payment bond in the amount of $24,000,000 was executed covering the construction of an addition and alteration to a hospital.

The contractor began to experience financial difficulties due to the tightening of the money market. Further, he was trying to complete an old contract at new labor and material prices. The contractor also owed a considerable amount of money on payroll withholding taxes, creating additional financial stress.

The contractor was in default and the surety was called in to make arrangements to relet the job. This job was rebid with a minimal time delay. The surety made payments to the suppliers and subcontractors bringing them to a current basis. The job was completed at a loss to the surety of $2,300,000.



Case II

A general contractor went broke on three contracts totaling $1,000,000 of which $700,000 was uncompleted.

Initially the surety financed the contractor. Due to other non-job obligations, the contractor couldn't complete the job. The surety arranged for another contractor to finish the project with the principal's work forces and original subcontractors. Construction was not interrupted or delayed as it would have been by a reletting of the contracts. Loss to the surety was approximately $450,000.

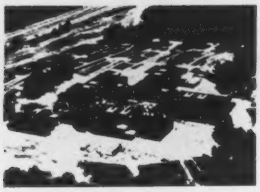
In many instances, the surety is made aware of contractor problems prior to default. In such cases, it often can take steps to avoid default. These include loaning money to the contractor, guaranteeing bank credit, providing consultation services and otherwise assisting the contractor in completing the contract.

18. Q. How long does it take to process a bond claim?

A. There is no single answer to this question. When a contractor defaults, a surety responds as quickly as possible since delay in the project merely adds to its costs. The size and complexity of the default, the duration of the project and the point at which the default occurred all have a direct bearing on the time it takes to complete a settlement. Other factors, such as the condition of the contractor's records, terrain, climate, type of project and other work the contractor might have undertaken, also have a bearing on the bond claim process.

19. Q. What is the owner's obligation under a surety bond?

A. An owner only has to perform his part of the contract to receive the protection of the bond. It should be emphasized that a bond will protect the owner's legal rights under the contract by assuring that there will be a responsible party available in the event of contractor default.



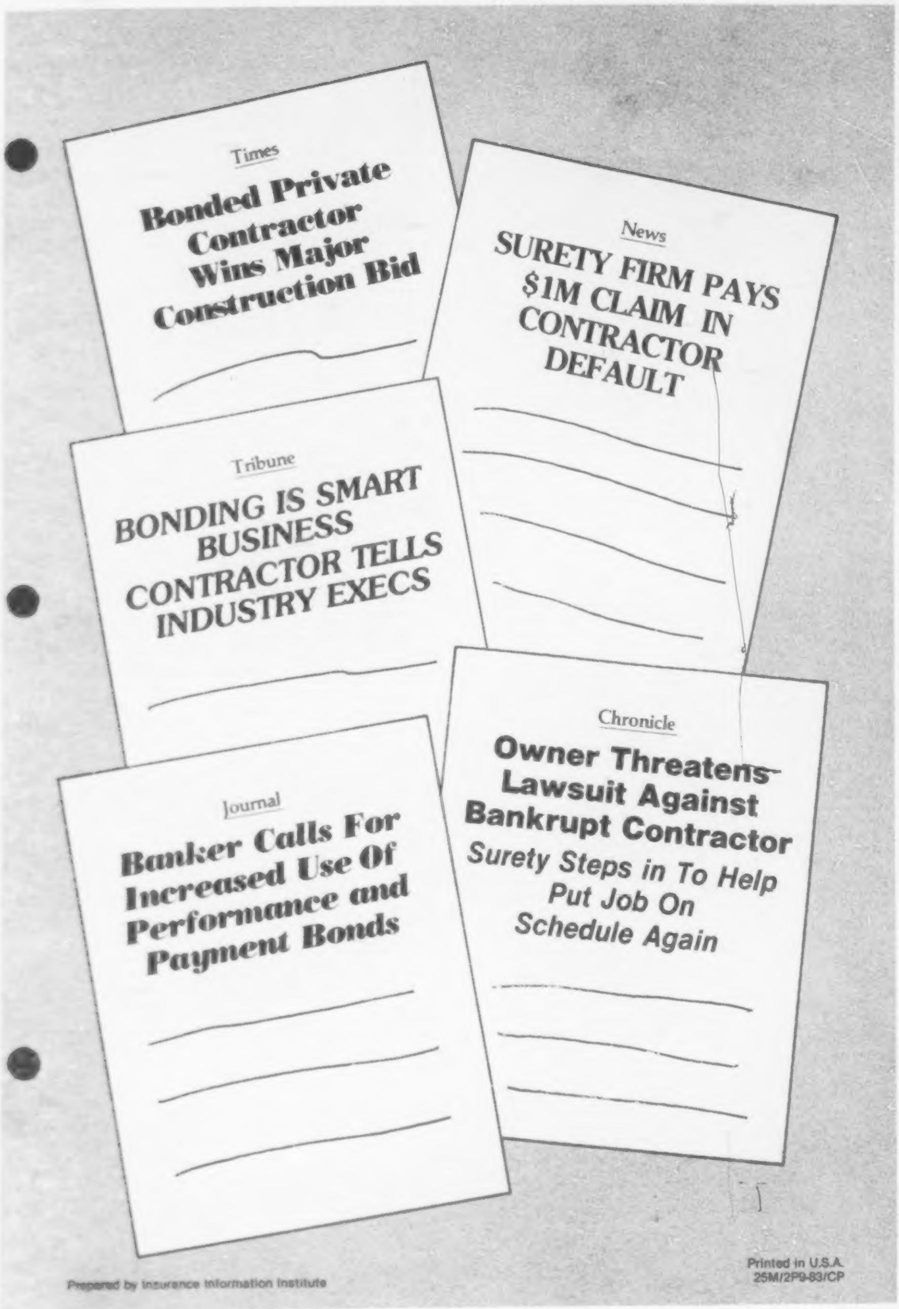
20. Q. It appears that requiring bonds on private construction projects is a prudent practice for any owner. How does one go about arranging for them?

A. The owner may simply include in the contract specifications a requirement that the contractor post bid, performance and payment bonds. The burden of obtaining bonds and delivering them to the owner rests with the contractor who will consult an independent insurance bond agent or broker.

Additional information concerning performance and payment bonds may be obtained by contacting either of the following organizations.

National Association of Surety Bond Producers
5454 Wisconsin Avenue, Suite 1625
Chevy Chase, Maryland 20815
301-986-4166

The Surety Association of America
100 Wood Avenue South
Iselin, New Jersey 08830
201-494-7600


Times
Bonded Private Contractor Wins Major Construction Bid
News
SURETY FIRM PAYS $1M CLAIM IN CONTRACTOR DEFAULT
Tribune
BONDING IS SMART BUSINESS CONTRACTOR TELLS INDUSTRY EXECS
Journal
Banker Calls For Increased Use Of Performance and Payment Bonds
Chronicle
Owner Threatens Lawsuit Against Bankrupt Contractor
Surety Steps in To Help Put Job On Schedule Again

Prepared by Insurance Information Institute

Printed in U.S.A.
25M/2P9-83/CP

The Surety Association of America . . .

is the trade association and licensed rating/advisory organization for the fidelity and surety lines of business.

Currently representing 538 American surety companies and three foreign affiliates, the Surety Association engages in educational activities, assists in developing potential markets and promotes the interests of suretyship in the U.S. and abroad.

The association also publishes and distributes a comprehensive manual of advisory rates, rules, procedures and classifications.

The National Association of Surety Bond Producers . . .

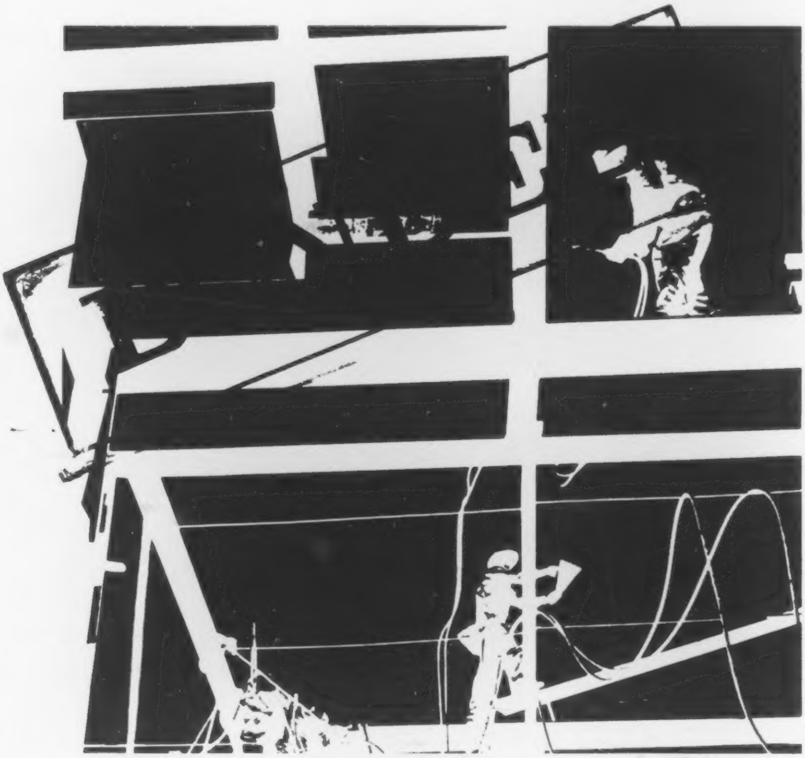
is the international organization of and for professional contract surety agents and brokers, through which members work toward the following aims:

- To encourage professionalism and a high degree of expertise in contract surety underwriting and production,
- To provide leadership in expanding the essential role of corporate suretyship, domestically and internationally, in cooperation with all facets of the surety industry,
- To promote cooperative activity and exchange of information among member firms,
- To foster more effective liaison and greater understanding among members and surety company personnel, and other surety industry organizations.

The Surety Association of America
(201) 494-7600

NASBP
NATIONAL ASSOCIATION OF
SURETY BOND PRODUCERS
(301) 986-4166

Bonding for Subcontractors



Published By The American
Subcontractors Association, Inc.
and The National Association
of Surety Bond Producers

Bonding for Subcontractors

A Guide to Contract Surety Bonding for Subcontrators

Jointly Published by

American Subcontractors Association, Inc.
1004 Duke Street, Alexandria, VA 22314-3512
(703) 684-3450

National Association of Surety Bond Producers
6931 Arlington Road
Bethesda, Maryland 20814
(301) 986-4166

NASBP

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DISCLAIMER: This publication does not contain legal advice. Individual circumstances vary widely, so readers should consult their attorneys before acting on the premises described herein.

Preface

Bonding for Subcontractors has been prepared for members of the American Subcontractors Association, Inc. (ASA) and other specialty and subcontractors by the National Association of Surety Bond Producers (NASBP) Liaison Committee with ASA.

Chapter Three, "Protecting Rights Under the Payment Bond," was prepared by Richard W. Miller, Esq., of the firm Miller and Bash, Kansas City, Missouri, assisted by James Betterman, Esq., of the firm.

NASBP and ASA hope that this booklet will help subcontractors to understand the valuable role of contract surety bonding in the construction process.

With 6,500 member firms representing all major construction trades and 55 chapters across the country, the American Subcontractors Association, Inc. is the only organization which speaks exclusively for the interests of subcontractors. ASA is dedicated to improving the general business conditions for subcontractors through unified and cooperative actions.

The National Association of Surety Bond Producers is the organization of leading agencies and brokerages in the United States, Canada and Puerto Rico which specialize in providing contract surety bonding and construction insurance programs to contractors. It is the mission of NASBP to encourage and promote professionalism and a high degree of expertise in contract surety underwriting and production. NASBP maintains liaison relationships with all major construction groups, including ASA.

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Chapter 1

What is Surety?

To Begin With: What is Suretyship?

The concept of suretyship is not new to the world. For centuries people have made promises to become obliged to others for the debt, obligations or conduct of third parties. This practice, whereby individuals would assume responsibilities for the obligations of friends or others is known as personal suretyship. Such arrangements often proved to have disastrous consequences; so much so that there became a wise old saying: "He that is surety for a stranger shall smart for it."

During the last 100 years in the United States, most surety guarantees have been issued by corporations rather than individuals. Most of these corporations are insurance companies since they have the longevity and financial resources to make sizeable commitments in the form of surety bonds. In addition, insurance companies engaged in the corporate surety business are regulated by state insurance departments. Personal or individual sureties still are found, but are unregulated by any governmental authority and should be avoided.

Suretyship, then, is the promise by which one party, the surety, becomes accountable to another party, the obligee, for the faithful performance by a third party, the principal, of an underlying contract between the principal and the obligee.

Surety and Insurance Compared

To understand suretyship, it is first necessary to understand how it differs from insurance. Although surety is classified as a line of insurance, a surety bond and an insurance policy operate in different ways. For example:

- Unlike the two-party insurance agreement, the surety agreement is a three party contract between the surety, the principal and the obligee.
- The surety bond is based upon an underlying contract which must be in writing.
- In surety, losses are not expected, as in the case in insurance, and premiums are not computed on the probability of loss. Insurance premiums are determined by actuarial methods. Surety is not subject to these methods, and the fee charged for a surety bond, also called a premium, is meant to pay the expenses of the surety company in underwriting the bond.
- The surety has special legal rights—and obligations. One of these called "subrogation" means that if the obligee turns to the surety for satisfaction under the bond, and if the surety, taking the place of the principal in fulfillment of the surety contract, suffers a loss or expense, the surety has all of the rights of the obligee under the underlying contract. "Indemnity" is the surety's right to be reimbursed by the principal for any such loss or expense.
- Performance or payment bonds are usually not cancellable—unlike an insurance policy.

Surety: A Form of Credit

While insurance is a risk-sharing device, surety is really a form of credit. Bankers, as you well know, extend credit either as actual money loaned or as a commitment to loan money, called a "line of credit." When a banker grants a loan, he fully expects to have the loan repaid, and he investigates the prospective borrower in sufficient detail to assure that this will be the case. A surety underwriter does the same thing—he thoroughly investigates the prospective principal to assure himself that he has the wherewithall to satisfactorily perform the obligation being bonded. No self-respecting surety underwriter ever expects the bond to be called upon.

Of course, since human judgments are fallible and external factors occur over which there is little control, both sureties and bankers often suffer losses. The surety industry saw this in the mid-1970's to a greater extent than ever before. In spite of this evidence, the industry clings tenaciously to its premise that suretyship is supposed to be a loss-free business.

What is a Contract Surety Bond?

We have seen, then, that suretyship is a guarantee of a promise. More specifically, a contract bond is a guarantee of the performance of a contract. Bonds are three party instruments by which one party (surety) guarantees or promises a second party (owner or general contractor) the successful performance of a third party (contractor or subcontractor). A bond is also an instrument of prequalification whereby one party says to a second party that the third party has been examined and found to be qualified to complete the obligation or undertaking in question. The three parties to a bond are the owner or general contractor (obligee), the surety (guarantor or obligor) and the contractor or subcontractor (principal).

The obligee is the entity or individual who is the beneficiary of the surety bond. When a prime contractor is required to provide a contract bond, the obligee is generally the owner of the project which the contractor will construct, and the prime contractor is the principal. When a subcontractor is required to provide a contract bond, the obligee is generally the prime contractor, and the subcontrator is the principal.

Kinds of Contract Bonds

Bonds issued by a surety for construction projects are generally bid bonds, performance bonds, and labor and material payment bonds. They can be separate documents or one or two combined documents.

The bid bond states that the contractor will enter into a contract, if one is offered, and that he will furnish whatever additional bonds are specifically required. If he fails to do either, the bid bond specifies a penalty which may be paid as damages.

While bid bonds are usually required of prime contractors rather than subcontractors, some states have filed subcontractor bid laws which require a bid bond from subs. Also, with the emphasis on construction management, many general contractors are taking bids themselves on specific contractor items and requiring bid bonds from their subs.

The performance bond states that the principal will build whatever it is he has contracted to build in accordance with the contract plans and specifications. A subcontract bond which may be required of a subcontractor by the prime contractor is a kind of performance bond.

The payment bond states that those people supplying labor and materials on a project will be paid subject to any restrictions and limitations imposed by statute or the contract or subcontract.

Why Bond Subcontractors?

The issue of a bonded prime contractor requiring bonds from his subcontractor is widely misunderstood as evidenced by the fact that this practice is commonly referred to as "double bonding." The connotation is that portions of the job are bonded twice, once by the general contractor under his performance bond, and again on those sections which are subcontracted and covered by a subcontract bond.

An owner of a construction project will hold the general contractor totally responsible for the prosecution of the contract. The owner is generally not interested in subcontract problems because he is paying the general to see to the performance of the subs. The responsibility for what subcontractors do on a job and how they do it rests with the general contractor. So, for the same reasons that an owner will require bonds from the general contractor, the general contractor will often require bonds from his subcontractors: to prequalify the subcontractor to protect against the possible failure to perform the subcontract, and to provide protection for the laborers and suppliers of the subcontractor.

Often, the project owner, especially in the private sector, may stipulate in his contract with the general contractor that certain subcontractors be bonded to the general contractor. From the owner's standpoint, the prequalifying of subcontractors by the surety reduces the possibility of disruption of the construction schedule because of possible subcontractor default.

Unfortunately, there is little uniformity among subcontract bond forms in use. The basic characteristic of a fair subcontract bond form is that its terms should be coextensive with the liability of the general contractor to the owner. Regretfully, however, many subcontract bond forms developed and used by general contractors are not fair to the subcontractors, and include onerous terms.

[An example of a fair subcontract bond form which adequately fulfills for the general contractor the anticipated indemnity for claims that arise on account of the subcontractor and for which the general contractor is liable for under his bond to the owner is shown on the opposite page.]

Surety as a Prequalification Service

We have already mentioned that a prime function of a surety contract bond is to prequalify a contractor. In the public sector, bonds are required under law for federal, state, county and municipal projects—at least from the general contractor. This is what makes the open, competitive bidding system work. If a government contracting authority is required by law to accept the lowest, qualified bidder, some way to screen out unqualified contractors must be employed. And since 1935, the year that the Miller Act was enacted by Congress, bonding has been the method mandated to achieve this prequalification task.

A 1976 General Accounting Office study affirmed the wisdom of the requirement for bonds, and stated that the federal government was not equipped to prequalify contractors itself.

This same prequalification function of surety can be an advantage to a general contractor who requires bonds from his subcontractors. Unfortunately, it is a common practice of some general contractors to require a bond only from subcontractors who the general contractor already knows may be less responsible: when there is some question about the sub's ability to complete the work at the price bid; when his performance rating is not high in the trade; when his credit standing and financial position is weak; when the sub is new or untried; or when the size of the work is greater than that which he has performed in the past. This is known as creating "adverse selection" against the surety, and some surety companies contend that they are not in the market for subcontract bonds because of this practice.

On the other hand, for many surety companies and for many professional surety agencies, subcontractors are a significant and valuable portion of their business.

Subcontract Bond

KNOW ALL MEN BY THESE PRESENTS, That we, ______________________________

____

whose principal office is located in the City of ______________________, State of

______________________, as Principal, and the ______________________

______________________, as Surety, are held and firmly bound unto ______________________

____

of ______________________, as Obligee, in the penal sum of ______________

______________________________ Dollars ($ __________),

lawful money of the United States for the payment of which sum, well and truly to be made, we bind ourselves, successors and assigns, jointly and severally, firmly by these presents.

THE CONDITION OF THIS OBLIGATION IS SUCH, That *WHEREAS,* the Principal entered into a certain Subcontract Agreement with the Obligee, dated the ________ day of __________, 19 ____, wherein the Principal has agreed to fully perform and complete the following work:

as more fully set forth in said Subcontract Agreement.

NOW, THEREFORE, if the Principal shall well and truly perform and fulfill all of the covenants, terms and conditions of the said Subcontract Agreement, and shall pay for all labor performed and materials furnished in the prosecution of the work provided for under the terms of the said Subcontract Agreement, then this obligation shall be null and void, otherwise to remain in full force and effect. No right of action shall accrue on this bond to or for the use of any person or corporation other than the Obligee named herein or the heirs, executors, administrators or successors of the Obligee.

IN WITNESS WHEREOF, The above bounden parties have executed this instrument, this ______ day of ______, 19 ____.

____
Principal

By______________________________

By______________________________
Attorney-in-Fact

Chapter 2

How a Surety Evaluates a Subcontractor

Gauging the Capacity to Perform

We have seen that a surety is concerned with guaranteeing a subcontractor's performance and the payment of bills. The surety will want, then, all of the information it can get to be assured of the contractor's ability to perform and to pay.

In order to show an ability to perform the proposed subcontract, you should make available the following information to the surety:

- **Resumes** of the key people in the firm will demonstrate their educational, professional and contracting background. Include the resumes of key inside people as well as key outside personnel. Do not be bashful, but by the same token do not be too boastful. Be as objective as possible in listing the relevant educational and employment backgrounds of all key personnel.
- **Track Record** of the firm, which is simply a listing of work successfully completed, means much to a surety. If the principal of the subcontracting firm was a project manager, foreman or superintendent for someone else, provide a list of the jobs supervised. If the firm has been in business for a while prior to applying for surety credit, give a description of each project completed, including the amount of each project, and the date completed. Some sureties may even ask for the largest work program handled to date by the firm.
- **Trade References** should be made available to the surety. List the names and addresses of project owners, general contractors, material suppliers, other subcontractors, etc., with whom you have worked. Any letters of commendation which you or your firm has received should certainly be volunteered.
- **The Continuity Plan** for the business should be outlined. The surety will be very interested in knowing what provisions have been made for the continuation of the firm in the event of the incapacity or death of key people. A one-man company doing a large long-term project represents a risky proposition to a surety because it would have to complete the project in the event of that individual's disability or death.
- **The Rationale** for wanting to do a particular project could be important to a surety. Especially in the case of a project or work program larger than anything done before, a subcontractor should be prepared to explain to the surety why he or she wants to embark on the project or program, how it fits into the existing work program or organization, how it will be financed, and what the return will be. For subcontractors, showing how the scheduling of a particular job fits in with other work, and how it will affect cash flow and utilization of labor, is especially important. The soundness of the reasoning may well be what makes or breaks the decision of the surety.
- **The Game Plan** of the firm should be made known to the surety. What are the plans for the future? What are the firm's objectives? What are the firm's five-year goals? Ten-year goals?

The purpose of providing all of this information is to show the surety that you have the ability to manage as well as construct.

Measuring the Financial Capacity

Financial capacity is probably the most complex portion of the subcontractor-surety relationship. We said earlier that the second part of a surety's guarantee is the payment of bills. It may be the second part of the guarantee, but it is where the primary losses originate. The losses occur because the "performers"—laborers, subsubcontractors, suppliers and sometimes the managers do not get paid.

It takes money to see that all of these people get paid, to start up a job, to carry a subcontractor over a period in which there might be a dispute with a general contractor or owner, to pay for ordered but unapproved changes, to finance retainage, to pay the overhead, to prepay bills and take resulting discounts, to finance slow receivables, and to insure the availability of bank credit. In short, it takes money to do everything, but it takes some people more money than others.

The amount of money needed can depend on the type of work being performed or the organization performing it. Therefore, while not attempting to prejudge how much money may be required or to set standards, here is an outline of the information a surety will want so that an evaluation of available funds can be made.

- **Credit References** for an existing company will show how bills have been paid in the past. There are various credit inquiry services to which sureties have access, but a subcontractor's own references will probably be more accurate.
- **Bank Credit** should be established and its extent made known to the surety. In this regard, remember that sur-

eties are generally looking for an unsecured line of credit which can be used for working capital purposes. Equipment financing, for example, would not meet this test, and financing based on an assignment of accounts receivable will not generally be looked upon favorably by a surety. Receivable financing tends to pit the surety against the bank in a default situation because of certain legal ambiguities in the Uniform Commercial Code.

- **Cost Records** are extremely important to a surety. Without a good cost recording and bookkeeping system, a subcontractor does not know where he stands financially at any given time. Because of the inherent risks of the construction business, it behooves every subcontractor, large or small, to have cost and bookkeeping systems that will show the financial status of his jobs. Without these systems, the subcontractor is not really in control and risks failure because of the inability to spot and correct problems before they become too severe.
- **Financial Statements** are vital to any credit-granting entity, particularly sureties. The balance sheet shows where a subcontractor stands financially and the profit and loss statement shows how this was achieved. Additional information, in the form of various schedules, is indeed essential to a proper interpretation and analysis of what is contained in the balance sheet and the profit and loss statement.

The old saying about computers, "garbage in-garbage out," applies as well to financial statements. If a subcontractor does not have good cost records, the figures will look fine on paper, but will not stand up to scrutiny or analysis. Therefore, engaging the services of a good accountant, preferably a certified public accountant is essential. A subcontractor should look for an accountant who knows the construction business and the peculiarities of construction accounting. The accountant handling the local hardware store, even if a CPA, may not know anything about construction accounting and will be of questionable value to the subcontractor and to the surety.

If you have been in business long enough, provide the surety with your past four years financial statements. Fiscal year-end reports should be stressed; interim reports are useful as supplemental data. Most sureties today are insisting on CPA audited reports with all applicable schedules and explanatory notes. There are occasions, however, when a surety will accept less than fully audited statements.

There are two kinds of unaudited statements that accountants may now provide, called "review" and "compilation." A review entails the use of some analytical procedures designed to see if the financial statements "make sense, " without applying audit-type tests to the subcontractor's own figures. If he does a compilation, however, the accountant provides no assurance at all regarding the figures because he is not required to perform any tests or procedures required to verify the numbers. In a compilation, the accountant simply puts the financial data furnished to him by the subcontractor into financial statement format. Sureties consider a compilation of little value.

Both compilation and review, however, depend on internally prepared figures which sureties generally do not like because they lack the stamp of approval of an independent auditor and are difficult to verify. So, for the purposes of surety credit, fully audited statements are definitely preferable. Audited financial reports should include as a minimum:

- Auditor's certificate
- Balance sheet
- Profit and loss sheet

It should be kept in mind that this is considered a minimum and will probably be insufficient for the purposes of most sureties. It is preferable to also include the following schedules:

- Work-in-process—showing contract price, original profit, billing to date, costs to date, cost to complete
- Completed work—showing contract price and also the gross profit
- Expenses—both general and administrative (if not broken out on the profit and loss statement)
- Source and use of funds
- Reconciliation of surplus
- Explanatory notes

If the statements are unaudited, schedules of accounts receivable, accounts payable, cash and fixed assets, if applicable, should be included as well.

If a subcontractor is on one income reporting method for taxes and another for other purposes, the surety should be told and furnished with either copies of both reports or a credit report plus a tax return.

There are four methods of reporting contract income:

- **Cash Method**—This income recognition method is exactly what the name implies. Only cash received is recorded as income and only cash expended is recorded as cost.
- **Accrual Method**—Accrual accounting allows for recognition of income when billings are sent out, regardless of when the money is actually received. Conversely, costs are recorded when invoices or requisitions are received regardless of when actually paid.
- **Completed Contract**—Under this method, income and costs for each job are recognized when the project is substantially complete.
- **Percentage of Completion**—This method allows for the recognition of income on the basis of the percentage of work completed. There are varying ways of computing this percentage, but the most common is the cost-to-cost method. The percentage-of-completion is determined by dividing the total cost of the job into the costs incurred to date. The resulting percentage is then applied to the contract price and the anticipated gross profit to determine the income and gross profit to be reported for the period.

These are all valid, acceptable methods of financial reporting and the choice of a method can be extremely important to the running of a business. A subcontractor's accountant should be seriously consulted regarding the choice of a method and its continuing application. In any event, full disclosure of financial statements should be made to the surety.

Putting Together the Work-in-Process Schedule

Work-in-process schedules should be done periodically and, as mentioned above, should include the contract price, the original profit, billings to date, cost to date, and cost to complete for each job. This important schedule tells the subcontractor and the surety:

Status of Each Job—
- How much is done
- How much is billed
- What the work has cost
- How much profit has been earned
- Estimated cost to complete

Status of the Company—
- How much gross profit it will earn
- How much it has borrowed from the job

It should not be surprising if the majority of the discussions with the surety agent and company involve the subcontractor's finances and financial structure. This is quite normal but it does tend to give a distorted picture of what the surety is looking for.

To keep the discussion in perspective, think of it this way: all of the elements of the subcontractor's case except his finances should represent a constant. That is to say, the subcontractor's organization, track record, and approach to a job, once demonstrated, are not generally questioned with any frequency if the subcontractor's operations are consistent. When a material change is made, such as added personnel with additional capabilities, initiating some data processing programs, or getting into a different type of construction, this information should be volunteered to the surety.

The subcontractor's financial situation, however, fluctuates from day to day, from job to job and consequently is the area that is subject to the greatest scrutiny from the surety, the bank and—even more importantly—from the general contractor. When applying for the first bond, and probably for subsequent bonds, remember that once the surety is satisfied with the ability to perform, it is going to look at the financial results of the subcontractor's performance and translate that into a decision on the firm's present and future ability to pay bills or to finance additional undertakings.

Personal Indemnification

The final item to be discussed with the surety will undoubtedly be the subcontractor's personal involvement with his company and with the surety. This is sometimes a sensitive area but it nonetheless is important and should be discussed with candor. A subcontractor will likely be asked to provide the personal indemnity of the stockholders of his company and probably that of their spouses as well. Those who indemnify will also almost certainly be asked to provide personal financial statements to show what that indemnity is worth. The initial reaction to this may be the determining factor in whether a subcontractor gets the bond, so it would be well advised to consider the subject carefully before a surety is approached.

It has already been explained that sureties are guaranteeing the subcontractor's performance and the payment of bills. Sureties prequalify, issue bonds and collect their fees. But simply because they have issued the bonds and collected their fees does not mean that sureties expect to be saddled with taking care of the subcontractor's obligations. They expect the firm to perform and to pay the bills. If it fails to do so, the surety expects the owners of the firm to do what any honorable businessmen would do if there were no surety involved: complete the contractual obligation using whatever means at their disposal. That means bank credit or even personal funds.

The surety can advance its own funds, guarantee credit at a bank or find someone else to complete the contract. But, if the surety does this, it expects to be reimbursed for the monies expended on the subcontractor's behalf. The indemnity agreement is the vehicle used to assure reimbursement from the company which has failed and the principals of that company. It also assures that those individuals will stand fast in the face of problems and use their talents and know-how to resolve the difficulties. This is important because in the past there have been numerous instances of people who, having no individual responsibility to a surety, have merely dumped a problem in the lap of the surety without attempting to offer any aid in solving it. They have walked away and left the surety to fend for itself, a situation which generally makes the solution to the problem more difficult and more expensive.

Since the vast majority of subcontracting firms are owned and operated by individuals or small groups of individual stockholders, the element of Character, one of the prime C's of credit analysis along with Cash and Capacity, becomes vitally important. The willingness of the owners to stand behind their company and support it with their personal assets is a very important consideration to a surety.

Chapter 3

Protecting Rights Under The Payment Bond

Subcontractor's Payment Bond Rights

The right of a laborer, supplier, subcontractor or anyone else who furnishes labor and materials to a prime construction contractor to be paid for their services has long been recognized. In order to protect such rights, the various states enacted lien laws to secure a certain priority of payment and thereby aid in the collection of sums due for services rendered on construction projects. However, since all federal property, in effect, is owned by the people, the courts have held it was neither right nor proper for liens to attach to any federal projects.[1]

In lieu of granting lien rights on federal projects, Congress enacted the Miller Act which, in addition to requiring a performance bond to guarantee completion of the project, requires a payment bond to be posted in a penal sum determined by the contract amount with the maximum amount on the payment bond being $2,500,000. The purpose of the Miller Act payment bond thus is to protect all persons supplying labor and material on United States government construction projects where lien rights are unavailable.[2]

Some states have adopted their own statutes which have been referred to as "Little Miller Acts" to protect subcontractors and suppliers involved with state construction projects. Although used as guidelines in state court decisions, the interpretation placed on the Miller Act by the federal courts is not binding in state court actions involving a "Little Miller Act."[3] Subcontractors are urged to consult their attorneys to determine exactly what must be done to protect their payment bond rights on state, county and municipal projects.

The Miller Act prohibits the governmental agency from waiving the requirements for posting a payment bond unless security equal to the amount of the required bond is deposited with the governmental agency.[4] It should be noted that while the act prohibits government agencies from waiving the bond posting requirements, the United States has been held not to be liable to unpaid subcontractors for the government's failure to enforce the bond posting requirements.[5]

Except for contract work in foreign countries where it is impractical for the contractor to furnish a payment bond,[6] the Miller Act gives those furnishing labor and materials on federal public works the right to sue prime contractors and their respective bonding companies in the name of the United States in the United States District Courts for such unpaid amounts, and this remedy under the Act is exclusive. This remedy is exclusive to the extent that it does not grant a substantive right on behalf of the subcontractor to directly sue the United States.[7] However, a subcontractor or supplier of material may proceed against a contractor seeking alternate relief on some common-law principle apart from recovery under the Miller Act Payment Bond.[8] One court has held that the philosophy underlying the Miller Act is to protect those who supply labor and materials to a federal project and because of this, the Act cannot be interpreted to limit or lessen the right of suppliers to look directly to the contractors for relief in state courts.[9]

Since the Miller Act was enacted for the benefit of those who are unable to take advantage of state lien laws because projects of the federal government are not subject to a lien,[10] the courts, including the Supreme Court, have ruled that the Miller Act is to be liberally construed in favor of those making claim on the bond.[11] While the Miller Act is to be liberally construed, this does not mean the courts will ignore the plain words of limitation in the Act and impose wholesale liability on Miller Act bonds.[12]

Projects Covered by the Miller Act Payment Bond

In order for the payment bond requirements of the Miller Act to apply, the project and the contract itself must involve the construction, alteration or repair of a "public building" or a "public work." The decisions by the various courts as to what constitutes a "public work," as used in the Miller Act, are very divergent and at times they might even seem contradictory. The Supreme Court has held that a library building at Howard University, funded under the National Industrial Recovery Act, was a "public work" for purposes of the payment bond requirement of the Miller Act since the Congressional Record indicated that the Miller Act was intended to cover the public works program then in force.[13] Another case broadly defined "public work" to include any project carried on with federal aid to serve the interests of the general public.[14]

The general rule is that in order for the project to be a "public work," there must be a prime contract to which the United States is party.[15] Based on this rule, the court held that the construction of an interstate highway in Kentucky pursuant to the Federal Aid Highway Act under a contract let by the Commonwealth of Kentucky precluded a claimant from proceeding under the Miller Act. On the other hand, a contract between a contractor and the California Institute of Technology for the erection of a building which the Institute was to operate under a contract with the United States was a public work for purposes of the Miller Act requirements.[16] Among projects considered to be "public works" for the purpose of invoking the Miller Act bond coverage were a post library on an army base even though the funds were not appropriated[17] and a base exchange at an Air Force base.[18]

The most important factor used by the courts in determining whether a project is to be considered a "public work" subject to the Miller Act is whether the federal government has title, or intends to take title to the project.[19] Thus, Miller Act coverage was not extended to a postal building erected by the contractor under a Postal Service leaseback arrangement.[20] Similarly, a low-rent housing development owned and administered by a municipality funded in part by the federal government, but without federal ownership, was not subject to the Miller Act,[21] and Capehart Housing projects were generally considered not subject to the Miller Act,[22] but there is case law to the contrary.[23]

In many instances the question of whether a Miller Act bond is required and has been provided is seriously considered by most subcontractors and suppliers only after they have performed work for which they have not been paid. Unfortunately at this stage the rights and obligations have already become fixed. It thus is critical that this determination be made by a subcontractor or supplier before a bid is submitted. At the outset it is important to determine whether the project is to be considered a "public work" for purposes of the Miller Act especially in this era where federal aid to state and local governments takes such form as grants from such federal agencies as the EPA. Grant regulations issued by these agencies may in some instances indicate whether the project is intended to come within the protection of the Miller Act payment bond.

As a general proposition, Miller Act payment bonds are required in those instances where a public project is involved and the prime contract:

a) is with the federal government;
b) is on Standard Form 23-A (or some similar type construction form);
c) is formally advertised for bids;
d) requires the prime contractor to provide a payment bond;
e) requires the prime contractor to perform construction activities (as opposed, for example, to being a supplier);
f) is authorized or funded by Congress; and
g) involves a governmental agency such as the Corps of Engineers which is basically construction-oriented.

In the event that a Miller Act bond has not been posted by the prime contractor, then the contract is voidable and can be terminated by the government at its option.[24] If the government does not terminate the contract, but allows the prime contractor to perform the contract without furnishing a bond and the prime contractor is unable to or fails to pay the claimant, the claimant obviously has no recourse against a surety. Furthermore the overwhelming weight of authority holds that such a claimant has no standing to sue the government for any retained funds since it is not in privity with the government.[25] In spite of that prohibition, a claimant should demand that the government act as a "stakeholder" and pay a valid claim for retained funds, if unexpended contract funds are available for payment, especially if the government would receive a windfall profit by not paying the retainage.[26]

Persons Protected by the Miller Act Payment Bond

Since the Miller Act protects those persons who have furnished labor or materials to contractors or subcontractors engaged in the construction, alteration or repair of any public building or public work of the United States, it is incumbent (after a determination has been made that the project is covered by the Act) to determine (a) the person's contractual relationship and (b) the particular labor or material involved and covered by the payment bond.

Coverage under the Miller Act and hence the right to bring an action on the contractor's Miller Act payment bond extends to those persons in direct contractual relationship with the prime contractor, and those who have a direct contractual relationship with a first-tier subcontractor, but have no relationship with the prime contractor.[27] The right to sue and recover under the Miller Act thus extends no further than the supplier to a subcontractor and a second-tier subcontractor (a sub-subcontractor), because these are the only persons who have a direct contractual relationship with a subcontractor of the prime contractor. The diagram on the opposite page indicates those persons who may maintain an action under the Miller Act bond.

Therefore these categories of persons expressly have no coverage whatsoever under the Miller Act:

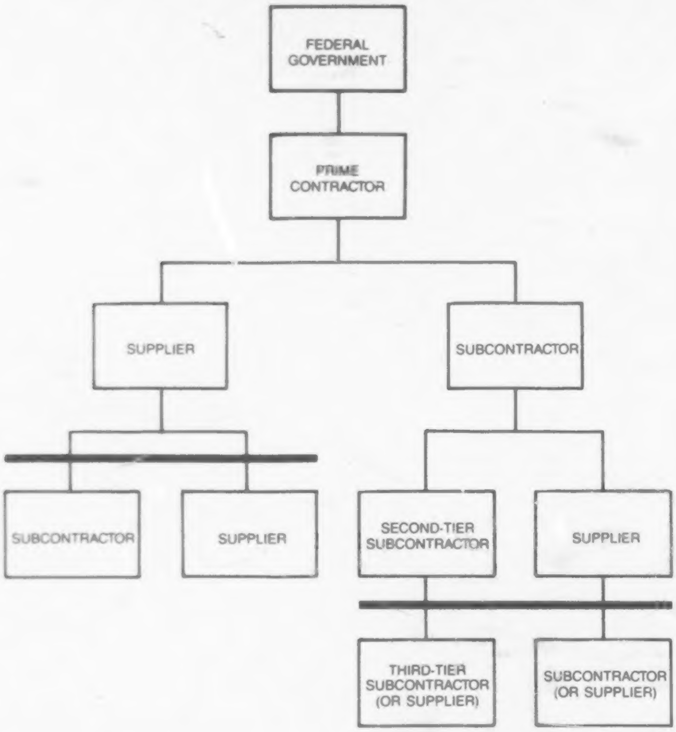
a) **A Third-Tier Subcontractor** who supplies labor and materials to a second-tier subcontractor cannot successfully sue on the payment bond furnished by the contractor;[28]
b) **The Supplier** of materials to a second-tier subcontractor has no right of action under the Miller Act against the prime contractor or his surety;[29] and
c) **Anyone** doing business with a supplier whether a second-tier subcontractor to a supplier or a supplier to a supplier is not covered by the Miller Act.[30]

More About Who Is Not Covered

With the specialization of various areas of construction and companies electing (for tax, labor or other reasons) to do business under multiple companies and different names, it is extremely critical for a subcontractor and supplier to know with whom it is doing business and its level

Persons Covered by A Miller Act Payment Bond

Persons above the heavy bar are protected by a Miller Act payment bond; those below the heavy bar are not so protected.


FEDERAL GOVERNMENT
PRIME CONTRACTOR
SUPPLIER
SUBCONTRACTOR
SUBCONTRACTOR
SUPPLIER
SECOND-TIER SUBCONTRACTOR
SUPPLIER
THIRD-TIER SUBCONTRACTOR (OR SUPPLIER)
SUBCONTRACTOR (OR SUPPLIER)

or tier in the overall scope of construction. This is important because the courts have ruled that where a subcontractor and sub-subcontractor are closely affiliated corporations, a third-tier subcontractor will still have no right of action under the Miller Act, even if both the subcontractor and sub-subcontractor are bonafide corporations doing business at arm's length.[11] Furthermore, a third-tier subcontractor will not have a Miller Act claim, even if he thought he was contracting and doing business with a first-tier subcontractor but was actually contracting with a second-tier subcontractor, unless he can prove the latter misrepresented that it was a first-tier subcontractor.[12]

Conversely, the presence of a dummy or non-operating sub-subcontractor may not be interposed as a defense to an otherwise valid Miller Act suit.[13] Similarly, a court held[14] that the subcontractor and sub-subcontractor will not be treated as a single entity for the purpose of providing coverage to a supplier or subcontractor to a second-tier subcontractor even though the subcontractor contracted all his work to the sub-subcontractor.

In addition, employees of second-tier subcontractors (sub-subcontractors) are also not entitled to recover under a prime contractor's payment bonds, since these employees do not have a contractual relationship with a prime contractor or a subcontractor.[15]

Supplier or Subcontractor?

Since coverage does not extend to anyone doing business with a supplier, the distinction as to who falls in the category of a subcontractor and who is a supplier is obviously critical to recovery under a Miller Act payment bond. In *MacEvoy v. United States* [322 U.S. 102 (1944)], which is the leading case with regard to the distinction between a subcontractor and a supplier, the court stated:

> "In a broad generic sense, a subcontractor includes anyone who has a contract to furnish labor and material to the prime contractor... But under the more technical meaning, established by usage in the building trades, a subcontractor is one who performs for and takes from the prime contractor a specific part of the labor or material requirements of the original contract..." This distinction has been followed in numerous cases.[36]

In reaching a determination as to whether a person is a subcontractor or a supplier, the courts have ruled that the difficulty and the exactness of the work being performed can elevate a person who normally would be considered a supplier to the status of a subcontractor—thereby giving coverage under the Miller Act to those dealing with him who otherwise would not be covered under the Act. Further, the presence or absence of the term "subcontractor" in a contractual agreement between a prime contractor and a middle party has been held to be of little probative value and will not control a court's finding on the subcontractor/supplier issue.[37]

The Fourth Circuit held that a company that fabricated steel girders for a bridge but performed no erection or other onsite work, was a subcontractor and not a supplier.[38] Although the agreement for girders was written as a purchase order for material, the court stressed the fact that "the agreement called not for mere supply of materials but for custom fabrication of massive girders and their accessories, key and integral components of the bridge, designed and fabricated to mesh precisely in their final assembly on the jobsite..."

Likewise, a company furnishing but not installing all kitchen cabinets for a housing project, who was required to verify room dimensions at the jobsite and to submit shop drawings to the architect for approval, was a subcontractor and not a supplier within the meaning of the Miller Act.[39]

Also, a company furnishing but not installing metal gates for a dam, which was required under its contract to submit shop drawings to the Corps of Engineers and which made gates that were solely designed for, and could only be used on, this particular dam, was a subcontractor and not a supplier under the terms of the Miller Act.[40]

Using these same guidelines, a court held[41] that a supplier of all the miscellaneous steel and iron products for the Manned Space Center was not a subcontractor since the variety and relative simplicity of the items being furnished weighed heavily against the finding that the supplier was a subcontractor.

The courts, in reviewing the underlying policy of the Miller Act, have established a strong policy of "liberal construction." In this regard the Courts have found that companies are subcontractors rather than suppliers in order to extend bond coverage where it otherwise might not exist. In one case,[42] the prime contractor let two contracts with firm "A"—one contract to perform certain millwork, and the other to supply all exterior plywood. The court held that firm "B" which supplied the exterior plywood to "A" in order for "A" to fulfill its requirements under its "supply" contract was eligible to bring a Miller Act suit. In so ruling, the court held that "A" in all its dealings acted as a subcontractor and not merely as a supplier—and thus the court treated the two contracts of "A" as a single subcontract.

In that case, the court went on to hold that merely because a company does not perform any work on the jobsite does not preclude its enjoying coverage under the Miller Act. Some states in interpreting their "Little Miller Acts" have refused to follow this rule.[43] If the type of work involved, the degree of responsibility assumed under the contract, and the nature and form of the agreement itself indicate that a subcontract relationship exists, a company which performs no actual work at the site may still be considered a subcontractor to afford protection not only to the company under the Miller Act but also to those dealing with the company.[44]

Labor and Materials Covered by Miller Act Payment Bonds

As a general proposition, anything which may be considered indispensable to the work which has been contracted falls within the meaning of "labor and material" as used in the Miller Act. The courts lean toward giving the words "furnished in the prosecution of the work" a liberal interpretation under the Miller Act. The test employed by many courts is whether the person furnishing the labor or material had a reasonable expectation in good faith that it would be used in the project.[45] In addition to a reasonable expectation that the labor or material would be used on the project, the courts have imposed the requirement that such labor and material must also have been considered necessary for the performance of the work.[46] However, there is no requirement that the claimant has to show that the prime contractor has benefited from the labor or material thus furnished.[47]

More About Materials Covered

In determining whether the materials furnished for the project are of a type covered by the Miller Act bond, the courts make a fundamental distinction on the basis of whether the material furnished is substantially consumed in the project or whether it remains capital equipment furnished by the claimant. This distinction was used as the basis for a finding that tires used on construction machinery in connection with a government contract were "materials" within the meaning of the Miller Act.[48] Among the items of material furnished by a supplier which have been held to be within the coverage of the payment bond are: water delivered to the general contractor for use in generating the steam to operate dredges as well as food furnished to the crews of the dredges[49]; lumber supplied for the construction of forms for pouring concrete[50]; gas and oil sold to a subcontractor for use on the job[51]; rented barge[52]; rented earth moving equipment[53]; and rented steel piling even though they were temporarily installed at the site and then later removed.[54]

The Miller Act does not cover a claim for the acquisition cost of tools used by a subcontractor.[55] The cost of equipment such as wheelbarrows, gas burners or gravel hoppers, which could not be expected to be substantially consumed during the construction project, cannot be recovered under the Miller Act.[56] Small tools and similar equipment such as ladders, which normally are expended on a project, have in certain instances, been accorded coverage under the Miller Act. It has been held that suit can be brought under the Miller Act for loss, repair costs and freight charges for tools and equipment furnished in prosecution of work.[57] In addition, a subcontractor who has constructed a particular item of equipment for particular use in a project, has been allowed to recover reasonable rental value for the equipment rendered idle by a contractor's breach of contract.[58]

Actual use on the project or incorporation into the project of the material furnished is not necessary to obtain coverage under the Miller Act for the unpaid cost of such material. The courts have further ruled that a subcontractor or a supplier suing under the Miller Act does not have the burden to show that the material he supplied was actually incorporated into the work—only that he reasonably expected it to be incorporated into the work.[59]

Courts have held that even though materials were never delivered to the jobsite or incorporated into the work, if the materialman in good faith had reason to believe the materials were intended for the work, they were covered by the Miller Act payment bond.[60]

In following these principles, a court held that stock replacement items for materials used in the work came within the coverage of the Miller Act although they were never actually incorporated or consumed in that work.[61] In another instance it was held that an unpaid supplier of material is covered by the Miller Act for supplying inventory replacement of material used in a government construction project.[62]

The Miller Act payment bond protects the supplier, even if the materials furnished were diverted to another project, as long as the supplier has a good faith, reasonable belief that the materials were intended for, and were going to be used on, the government job.[63] However, in another case, the supplier was barred from recovering from the surety because the supplier knew the subcontractor diverted the goods from the government job to another job.[64]

Funds borrowed to finance contract operations have been held by the courts not to be either materials or labor, and the lender thus has no claim of coverage under the Miller Act.[65] It has also been held that an extension of credit to a prime contractor by a subcontractor does not of itself permit those funds to come within the coverage of the Miller Act.[66] A person who extends credit is not a materialman or supplier of labor within the meaning of the Miller Act, even though the monies thus realized are used to pay for materials and labor used in the prosecution of the work.[67]

The courts are split as to whether or not delay damages which are sustained by a subcontractor or supplier because it was delayed in performing its work can be recovered under the Miller Act. Several courts hold that delay demages are "lost profits" and cannot be recovered under the Miller Act because it only allows for recovery of the amount provided in the contract.[68]

Those courts which have allowed recovery of delay damages have done so on the basis that these damages, in effect, involve actual expenditures for labor or materials utilized in the performance of the government project and thus are covered by a Miller Act bond.[69] Some courts have held that the claimant must not have caused the delay in order to recover on the bond, but an appellate court ruled that if both the prime contractor and subcontractor contributed to the delay, the delay damages recoverable under the Miller Act bond would be apportioned on the basis of who caused what damages.[70]

More About Leased Equipment Covered

The agreement which a subcontractor has concerning the equipment used on a project could determine whether payments due in connection with such equipment can be recovered under the Miller Act. The courts are almost uniform in holding that equipment "leased" under agreements styled "lease agreements", but which are really a conditional sales contract, are not within the protective scope of Miller Act bonds. The court's rationale in denying Miller Act protection to conditional sales contracts is based on the fact that the purchase price of equipment is not consumed in the work, and thus should not be covered by the bond. The question of whether a lease of equipment is actually a conditional sales contract for purposes of the Miller Act bond has been considered and determined.[71]

A lease of equipment with an option to purchase has been treated in some jurisdictions as not covered by a Miller Act bond. However, the better reasoned rule (insofar as applying the law to industry practice in such a transaction) was expressed by the Eighth Circuit Court of Appeals in the *United Pacific* case.[72] In *United Pacific,* the court set forth the criteria which must be met for a lease-option to be covered under a Miller Act bond. The Eighth Circuit stated that the optionee-lessee should have the right to allocate and recover under the bond for that portion of the lease payment which was for the use of the equipment but that the lessee cannot recover for any part of the acquisition cost.

The court in *United Pacific* relied on an earlier Eighth Circuit case in which a lease agreement with an option to purchase was held to be a lease that was covered by the Miller Act.[73] The agreement was held to be a lease, even though the contractor had the right to retain the equipment after making only seven monthly payments which covered the entire value of the equipment. The court stated that this option raised questions as to the meaning of the contract. In making its final determination as to the true meaning of the agreement, the court determined it must take into account all of the provisions of the agreement and the intent of the parties.[74] The court found evidence that the agreement was: typical for the lease of equipment in this industry; the amount of rental was not unreasonable; and the language of the agreement was typical of a lease agreement.

More recently, another court has used this analysis of the agreement's terms and the surrounding circumstances to determine if the agreement was a lease or a conditional sales agreement.[75] The court denied a "lease" agreement Miller Act bond coverage, because the various provisions in the agreement required the "lessee" to take certain actions that were more consistent with a conditional sales agreement than a lease agreement. For example: the "lessee" was to insure the equipment in favor of the lessor; was to pay the taxes, repairs and maintenance of the equipment; was required to make high front-end payments; was required to make rental payments that were not in line with the fair rental values for that equipment at that time; and finally, there was an understanding that the "lessee" would own the equipment at the end of the lease for the nominal payment of $1.00. The agreement was styled by the parties as a lease, but the court found that the manner in which the agreement was styled did not determine its character.[76] Finally, although the parties may have claimed the intention of making a lease, the court stated that these intentions will not make the agreement a lease for tax or Miller Act purposes, if the economic realities of the transaction make it an installment sale and not a lease.[77]

In considering whether a lease-purchase agreement comes under the protection of a Miller Act bond, the following are important to be kept in mind:

a) A problem could exist if the amount of the purchase price in the purchase section of the agreement is for a nominal amount.

b) The chance of coverage is stronger if the lessor insures the goods, even though the lessor builds into his rental payments the cost of insuring such items.

c) The ability to maintain bond coverage is strong if the lessor pays for the taxes, repairs and maintenance, again building the cost, or the expected cost, of these items into the rental agreement.

d) A provision in the agreement stating that the agreed dollar amount for the rental of the equipment is the customary and normal rate for the industry in that geographic location helps substantiate that the parties intended this to be a lease and not a purchase.[78]

e) Probably the single most compelling argument in courts interpreting whether a lease-purchase option is a security agreement and not a lease, and thus, not qualifying for protection under a Miller Act bond, is whether the "lease" and "lease" payments defy the economic realities of the transaction.

More About Labor Covered

In keeping with the intent to construe liberally the terms of the Miller Act, the tendency of the courts is to give an expansive definition to the word "labor."[79] Thus, the meaning of the word "labor" as used in the Miller Act is not restricted to physical labor, but is given a broad construction to accomplish the remedial nature of the statute. For example, the services of a general superintendent on a dredging project were equated to the services usually rendered by a foreman and were considered labor for purposes of coverage under the payment bond.[80] Skilled, technical and professional services used in the inspection and testing of work are within the meaning of the word "labor"[81] and thus covered by the bond. Furthermore, services performed in connection with the transportation, loading and unloading of materials have specifically been held by the Supreme Court to be "labor" within the meaning of the Miller Act.[82]

Contributions to employee welfare funds are clearly covered under a Miller Act payment bond,[83] but workers' compensation insurance premiums, although based on, and related to, the labor expended on a project, are not covered.[84] However, if the payment of workers' compensation insurance premiums are required by an agreement between the contractor and the labor union to be made to a trust fund for the benefit of the employees, such payments are within the coverage of the Miller Act.[85]

The furnishing of medical and hospital care to the emplyees of a contractor are not within the meaning of the word "labor" for purposes of recovering under the Miller Act payment bond.[86] Similarly, claims for workers' compensation are not recoverable under a Miller Act payment bond.[87]

Prior to 1974 the jurisdictions were split as to whether attorney's fees required to maintain an action under a Miller Act bond were reimbursable by the payment bond surety. In 1974, however, the Supreme Court declared that attorney's fees under a Miller Act bond would not be recoverable in the absence of a statute or contract providing for that recovery, unless it was found that the losing party acted in bad faith, vexatiously, wantonly, or for oppressive reasons.[88] The court clearly indicated that any deviation from the "American rule" with regard to Miller Act litigation was an area for Congressional action, not for the court. However, Congress has not passed a bill to override this decision with regard to attorney's fees. If the state in which a Miller Act suit is filed has a statute allowing for the payment of interest to the attorneys representing the claimant, then recovery of those fees should be allowed to the claimant, if he is successful in his suit. In contrast, one District Court has specifically held that Federal, and not State law, governs the award of attorney's fees in Miller Act cases. The court said attorney's fees will only be awarded upon a contractual basis or where the opposing party acted in bad faith.[89]

More About Taxes Covered

A 1966 amendment to the Miller Act changed the law to mandate that every "performance bond required under this section shall specifically provide coverage of taxes imposed by the United States which are collected, deducted or withheld from wages paid by the contractor in carrying out the contract with respect to which such bond is furnished."[90] Before this amendment, it was generally held that the Miller Act bond did not cover Social Security and withholding taxes which the contractor failed to pay into the Treasury of the United States.[91]

On its face, the Miller Act only makes a surety liable for withholding taxes, and does not impose liability for interest and penalties. Currently, no appellate court has passed on this issue of a surety's liability for interest and penalties assessed for the contractor's unpaid withholding taxes. One district court has allowed the Government to assess the penalties against the surety and its Miller Act bond. However, the court based its holding on a state statute that allowed the assessment of penalties against a surety when the surety contests the underlying debt.[92] In another district court case, the court disallowed the Government's penalty claim.[93] In this case, the court noted that the Miller Act made no provision for penalties on withholding taxes, but the court did admit that both interest and penalties are included in the definition of the word "tax" under §6659(a)(2) of the Internal Revenue Code.[94] The court held that this specific statutory reference was not enough to impose the liability for penalties on the surety, without authorization by a state statute. It should be noted that in this case the surety had already paid the interest on the taxes owed and had admitted the underlying liability for the tax claim.[95]

Finally, one district court has awarded the Government interest and penalties on the Government's claim against a Miller Act surety.[96] Here the court held that Colorado law allowed for the imposition of penalties against a surety and that the assessment of penalties and interest were proper, as the surety had denied liability of the underlying taxes owed and had paid nothing towards the taxes or interest. Further, the court held that a penalty is a tax, as the Internal Revenue Code clearly defines "penalties" as "taxes."[97] However, the sections of the Internal Revenue Code that the court used for this definition of "taxes" specifically state that they apply only to the Internal Revenue Code which has not been incorporated by reference into the Miller Act.[98]

Defenses to Payment Bond Claims

If the prime contractor or its surety can demonstrate that the payment bond has been discharged, released or waived, then the prime contractor and its surety are not responsible for claims of persons furnishing labor or materials to a subcontractor since there is no privity of contract with the prime contractor. One of the major defenses asserted by prime contractors and sureties in an effort to avoid liability on the bond is payment in full.

Payment to the Subcontractor

Payment is only a valid defense to an action brought by a supplier or subcontractor under the Miller Act if the supplier or subcontractor has actually received payment. Thus a Court held that the prime contractor, even though it had paid its subcontractor in full, does not escape liability to an unpaid supplier of his subcontractor because the Miller Act imposes on the prime contractor the duty to see that actual payment was made to the supplier.[99] A joint checking agreement between the prime contractor and one of its subcontractors whereby the prime contractor delivers its payment to his subcontractor by checks requiring the joint endorsement of the subcontractor and materialman does not afford a defense if the materialman actually was not paid.[100]

As recently as October 21, 1986, the Ninth Circuit reaffirmed that a joint checking agreement was no defense to a prime contractor who was sued by his subcontractor's supplier for nonpayment. In this case, the supplier not only signed a UCC-1 document transferring ownership of the equipment supplied to the prime contractor, but also signed an endorsement clause on the reverse side of four separate joint checks. The endorsement required the supplier to acknowledge full payment for all material and labor provided up to that point. When the subcontractor declared bankruptcy, its supplier sued both the prime contractor and its surety under the Miller Act. The prime contractor and its surety argued that the supplier was not entitled to recovery under the Miller Act on the grounds that its acceptance of the endorsement provisions on the joint checks constituted a waiver of its rights under the Miller Act. The Ninth Circuit held that there was no waiver because there was insufficient consideration for the release.[101] Furthermore, a supplier does not lose his Miller Act right when he deducts from a joint checking account those amounts currently owed him.[102]

A subcontractor or the supplier of a subcontractor must apply funds received from the subcontractor to the specific account for the specific government project, if the subcontractor or supplier knows the funds originate from a contract on a government project.[103] When a sub-subcontactor or supplier has knowingly misapplied funds, those funds must be reallocated to the proper accounts.[104] This rule is based on the principle that it would be manifestly unfair to allow a sub-subcontractor or supplier to satisfy old debts on unbonded jobs out of funds received on current government projects and thereby retain a substantial claim on the Miller Act bond.

Once a sub-subcontractor or supplier has proven that there is a balance due on a Miller Act bond and has proven the other aspects of its case, as discussed previously, then the defendant (whether it be the prime contractor or its surety) has the burden of proving by a preponderance of the evidence that there has been a misapplication of funds. An appellate court reversed a lower court ruling which found a misapplication of funds by a supplier and imposed a high standard on a prime contractor to prove misapplication of funds.[105] The court held it was equitable to impose such a standard on the prime contractor since the court determined that the prime contractor could have protected itself: (a) by issuing joint checks to the supplier and subcontractor; (b) by requiring the subcontractor to post a bond; or (c) by contacting the supplier directly to verify the payments and the application of payments. This rationale of the court on joint checks fails to consider that if the subcontractor forges the supplier's endorsement, the prime contractor and its surety are not protected since the supplier still has a viable Miller Act case since payment was not received by the supplier.

Effect of Board or Arbitration Proceedings

The fact that there is a dispute between the government and the prime contractor in connection with the subcontractor's claim normally does not affect the claimant's rights to proceed on the bond under the Miller Act. Since the government does not have privity with the subcontractor and has no legal obligation to him, a requirement that the subcontractor submit his claim under the disputes clause of the prime contract will not require him to surrender his rights under the Miller Act.[106] Courts are reluctant to incorporate into a subcontract the provisions of a prime contract which could adversely affect the rights of a subcontractor under the Miller Act. Because of this, subcontractors are generally not subject to the disputes clause in the prime contractor's contract with the government,[107] unless there is a showing of clear subjective intent on the subcontractor's part to have disputes resolved according to the incorporated clause.[108] However, it should be noted that courts interpreting state statutes similar to the Miller Act will not necessarily follow this reasoning.[109]

If the supplier or subcontractor agrees to be bound by the governmental board or court regarding disputes with the prime contractor, then the supplier or subcontractor must preserve its Miller Act suit by filing it in a timely manner. However, the suit may be held in abeyance and stayed until the board or court rules.[110] Similarly if there is an arbitration provision in the contract, the suit to enforce the Miller Act bond rights should be timely filed, recognizing that it will be subject to a stay order being issued until the arbitration is concluded.

Waiver of Miller Act Rights

The courts have uniformly held that because of the remedial nature of the Miller Act, a waiver of a subcontractor's or supplier's rights under the Act must be clear and explicit. A payment to a subcontractor and the materialman jointly by check containing a stamped waiver was held not to be binding on the supplier.[111] Nor does the inclusion of provisions in the prime contract void the rights of a subcontractor or supplier to proceed under a Miller Act bond.[112]

Instituting an Action Under a Miller Act Payment Bond

The Miller Act provides that those sub-subcontractors and suppliers who have a contract only with a subcontractor must provide written notice to the prime contractor within 90 days from the date on which such sub-subcontractor or supplier performed the last labor or supplied the last of the material for which the claim is made. There is no notice requirement imposed upon subcontractors and suppliers who deal directly with the prime contractor.[113]

The Miller Act speaks in terms of the 90 days notice running from the date the "last" labor or material was supplied. What is the effect if the second-tier subcontractor or supplier gives notice before he fully performed his contract? Currently, the courts are split. The Third Circuit decided that notice given before the actual final day of work was premature and therefore, dismissed the suit.[114] The Fourth Circuit took the opposite approach by holding the second-tier subcontractor or supplier can give notice at any time during performance, and not just after the last day of actual performance.[115] "The notice is timely if given within 90 days after performance of the last labor or supply of last material for which such claim is made." However, the Fourth Circuit limited the second tier subcontractor or supplier to recovering only those damages that accrued prior to the notice.

When is the notice to be given if the sub-subcontractor pulls off the project with the expectation of returning but is not permitted to return to work? The courts have ruled that the 90-day notice period begins to run when a second-tier subcontractor leaves the job site, even if he expects to return and finish the work.[116] In order to avoid a notice being considered untimely under such a circumstance, the notice should be given. However, if the sub-subcontractor is permitted to return to work within the 90-day period, then the notice could and should be retracted and then resubmitted once the work is finished.

As to lease payments, the courts have determined that the 90 days begin to run for a lessor on the day the subcontractor (lessee of equipment) ceases work on the project.[117] Thus, rental payments have no relationship to the 90-day notice period. Notice given when the subcontractor fails to pay rent at the time(s) required by the lease, but before he ceases work, would be untimely and might lead to dismissal of the suit or reduction of the amount which the lessor can recover depending in which circuit the suit is brought.

In a 1979 case, the court had to resolve the 90-day notice provision in a situation involving a supplier who had a contract with the subcontractor who went bankrupt, but the prime contractor still needed materials from the supplier.[118] The prime contractor paid the supplier directly for the materials the prime contractor purchased. The supplier wanted the 90 days to run from the date it last supplied goods to the prime contractor, but the court rejected this argument and held that the 90 days began to run when the supplier last delivered goods that the subcontractor ordered.

Even if a sub-subcontractor has not given notice within 90 days from the date he last performed work, one court has allowed a second-tier subcontractor to base the 90-day notice period on a third-tier subcontractor's last day of performance.[119]

Special notice requirements are placed upon the United States where the government intends to bring suit under the Miller Act for collection of unpaid withholding taxes. The United States must give the surety written notice of the unpaid withholding taxes within 90 days of the date on which the contractor files a quarterly withholding tax return on those taxes. In addition, the notice must be provided to the surety within 180 days of the quarterly withholding return's due date.[120] In other words, for the government's notice to be timely, the surety must receive notice of the unpaid taxes within 90 days of the filing of the contractor's quarterly withholding tax return, but not later than 180 days of the quarterly withholding return's actual due date.

Sufficiency of the Notice

To be in compliance with the Miller Act, the notice must name the recipient of the labor or material and the amount of claim with substantial accuracy.[121] Such notice is a condition precedent to the exercise of the claimant's rights.[122] Oral notice will not meet the statutory requirement.[123] The notice must be in writing and must be sent or presented to the prime contractor by, or on authority of, the claimant and must inform the prime contractor, expressly or by implication, that the claimant is looking to the prime contractor for payment of the claimant's bill.[124]

All the statute requires is substantial accuracy; thus a statement of the exact amount owing to the claimant need not be contained in the notice.[125] Although the statute requires that notice "shall" be by registered mail, the courts tend to excuse this requirement when it is shown that a prime contractor has actually received notice.[126] One court has held that the purpose of the Miller Act's manner of service requirement was not to establish a condition precedent for maintaining a suit, but was simply to provide a mode of service which would afford sufficient proof of receipt of the required notice.[127] The failure to follow the statute precisely in this regard needlessly furnishes the prime contractor and its surety with a defense to an otherwise recoverable Miller Act suit.

Suit Must be Brought Within One Year

Section 270b(b) provides that no suit may be maintained on the bond by a claimant "after the expiration of one year after the day on which the last labor was performed or material was supplied by him." Technically, the claimant must file his claim after the 90-day notice period has expired but before the one-year has passed. Notice filed before the 90 days have elapsed is premature, and the claimant who files suit after one year from the last work or material was supplied is too late. In a case where the claimant filed suit prior to the 90-day period having expired, the district court refused to allow the claimant to file a supplemental pleading and dismissed the suit.[128] The First Circuit reversed and allowed the supplemental pleading holding there was no prejudice to the surety and no purpose of the Miller Act or federal rules would be served by denying the claimant relief.[129]

The one-year period for filing suit under the Miller Act is statutory and jurisdictional, and is not subject to waiver by the defendant either expressly or implicitly.[130] Neither administrative consideration of the claim such as by the Corps of Engineers Board of Contract Appeals nor arbitration nor any other court proceeding can toll the running of the one-year period.[131] The one-year requirement for filing a Miller Act suit is not excused merely because the contending parties are engaged in ongoing negotiations in an effort to reach settlement. However, if a subcontractor or supplier does not file his suit within the one-year period as a result of being misled to his detriment by representations of the other party, the surety may be equitably denied the defense of untimeliness.[132]

Although many construction subcontracts contain provisions requiring that parties submit their claims to arbitration, the presence of the arbitration provision does not operate to suspend the one year limitation of the Miller Act. One procedure in such circumstances is to file the Miller Act suit within the statutory period and then request a stay of proceedings pending the results of the arbitration.[133] The refusal of the court to grant a stay pending arbitration in the Miller Act case is appealable.[134]

Venue for Miller Act Suits

Section 270b(b) of 40 USC provides "Every suit instituted under this section shall be brought in the name of the United States for the use of the person suing in the United States district court for any district in which the contract was to be performed and executed and not elsewhere. . ." Therefore, there is no choice of forum, and the plaintiff is required to resort to the federal district court for the district in which the work was performed.

Some courts demand strict compliance with this venue requirement. In one case the claimant filed the suit in the Eastern District of Louisiana, but the contract was actually performed in the Western District of Louisiana.[135] The Fifth Circuit remanded the case to the Eastern District Court to determine if the interests of justice required that the suit be dismissed or transferred to the Western District Court. However, in an earlier case, the Court ignored the improper venue on the basis it did not effect any substantial rights of the parties, and the court refused to order the additional delay and expense of another trial in the proper district court.[136] Since the venue requirement refers not to the jurisdiction of the Court but rather to the venue, this venue requirement may be waived by the defendant.[137]

In order to make service of process on a defendant under the Miller Act, the entire United States and its possessions are within the jurisdiction of the Federal District Courts.[138]

Chapter 4

Special Bonding Problems

Performance Bond Claims

We have discussed subcontractor rights under the general contractor's payment bond. But what happens if a bonded subcontractor defaults on a contract? There are generally two routes through which a case can end up in a surety's claim department.

First, the subcontractor may default for failure to perform because he has run out of money, or because the subcontractor finds that the project is beyond his ability to perform.

Second and more commonly, the subcontractor may realize before actually defaulting that he is in trouble, and wisely call in his surety.

In either case, the first action of the surety is to investigate the facts and determine the nature of the problem. Sometimes this process can take longer than the subcontractor or the general would like, but the surety is entitled to look before it acts.

In the event of a pending voluntary default, the surety will want to ascertain that there is a genuine reason for its involvement. Many times a subcontractor will actually believe that he is going into bankruptcy when in fact he is having a temporary cash flow problem. In such cases, the surety may conclude after its investigation that the contractor can in fact survive without the surety's direct involvement. It may reassure the subcontractor's bank and his creditors of its support and institute a system for maintaining job progress review and the payment of bills. But it may not have any financial involvement.

On the other hand, the surety may perceive that a genuine problem exists and that it will be called upon to fulfill its obligations. In such cases, the first thing the surety must do is obtain a letter from its principal under the bond—the subcontractor—requesting its assistance. Without such a request, the surety in the absence of a default by the prime contractor may be construed to be a volunteer, which could void the surety's rights under the indemnity agreement and possibly its subrogation rights. Once the surety has determined the scope of the problem and the extent of its responsibility, it will decide on the best method of solving the problem and fulfilling its responsibilities.

The Surety's Available Options

Basically, there are three options available to a surety with which to cure a default situation. These three options are:

- The surety can finance the subcontractor until all of his obligations are satisfied. The advantage of this method is that it masks from creditors the fact that the subcontractor is in difficulty thus keeping the subcontractor afloat, his organization together and the subcontractor, who may be the only one who knows the problems of the job, on the job. If the subcontractor stays involved, job continuity and momentum are maintained. The disadvantage is that this method can result in the expenditure of more dollars than the surety may really be liable for. In addition, unless the projects are inherently profitable or there are significant assets outside the construction company, it makes recovery of funds by the surety difficult. It can also lead to extreme pressure to continue to guarantee new work to generate profits to offset the loss.
- The surety can relet the project to another subcontractor. Again, there are both advantages and disadvantages. The loss can be reasonably well defined by virtue of the signing of a contract with a new subcontractor. However, the surety runs the risk of alienating the original subcontractor and making recovery difficult. Furthermore, the original subcontractor will be known as one having problems and could be forced into bankruptcy with all the additional problems that situation may raise.
- The surety may let the general contractor finish the project and reimburse him up to the limit of the bond.

The Small Subcontractor

It is not unusual even for an experienced small subcontractor to have some difficulty in obtaining surety credit. In large part, this problem is rooted in the poor surety industry results in recent years when many losses were suffered. These losses restricted the surety marketplace and its capacity to underwrite bonds. In an attempt to reverse the loss picture, most sureties reassessed their contractor portfolio and concluded that small contractors were qualitatively a riskier proposition and also that they were expensive to handle. Different sureties reacted to this conclusion in different ways. Some set minimum financial limits involving minimum net worth or working capital. Some sureties established $25,000 as a minimum while others used figures of from $50,000 to, in some cases, in excess of $100,000. Minimum experience requirements and minimum years in business were also imposed and in some cases outright rejection was the tactic for declination.

The underlying rationale for minimum financial requirements appeared to be that the lack of a financial cushion left a contractor unable to sustain himself in the event of an impairment of his cash flow, a significant loss on a job or a long period without work where existing capital was consumed by overhead. It does not appear that the future will change the situation for small contractors, especially considering the continuing high level of competition and low profit margins in the construction industry.

This is not intended to discourage small subcontractors. Instead, it is an attempt to explain a situation which in fact does exist. Obviously, a small subcontractor who generates profits and retains them in his business will eventually exceed minimum financial requirements and grow into a desired risk if not into a large subcontractor. Also, several surety companies during the past few years have adopted a policy of doing everything possible to provide bonds for small and emerging contractors.

Surety Bond Guarantee Program

In 1968, the U.S. Small Business Administration (SBA) was granted the authority to issue guarantees to surety companies whereby the SBA would reimburse a surety for losses up to 90 percent of any bond written up to certain stated limits. There were size standards established which governed a contractor's eligibility for the program and a fee schedule was promulgated. Today this program is available for use by eligible small contractors regardless of race, age or sex.

Up to now, the SBA surety bond guarantee program has provided guarantees on billions of dollars of construction bonds thus enabling the sureties to accept riskier proposals which they might not accept if they had to absorb all the potential losses by themselves. The program has not alleviated the concern of the sureties regarding a lowering of their standards nor has it allayed fears about excessive government intrusion into private business. However, as a pragmatic solution to a difficult problem, the SBA program has functioned reasonably well.

Chapter 5

The Surety Agent

The Role of the Professional Surety Bond Agent

The fact that most surety companies will only accept business through independent agents and brokers works to everyone's benefit. The subcontractor has an opportunity to dress rehearse every proposal and has the advantage of having someone available for consultation who is not necessarily only thinking in terms of either accepting or declining the bond application. Mutual confidence can be generated between subcontractor and agent. This confidence can be turned into candid and practical suggestions and advice which can then be translated into positive approaches to a surety in terms that the surety can understand.

To put it another way, the agent translates what the surety says into terms the subcontractor can understand and vice versa. The ideal subcontractor-agent-surety relationship is based on candor, confidence and communication. The subcontractor who peddles his case to a number of agents, the agent who peddles his case to a number of companies and the surety which declines without sufficiently giving its reasons all break the candor, confidence and communication criteria to someone's detriment.

In every endeavor there is a right way to do things and a wrong way. Similarly no one does everything right all the time. The surety business is no different. Surety people depend on the construction industry for their livelihood. Therefore, they are deeply interested in keeping subcontractors and their businesses healthy. The best way to accomplish that end is for all parties to keep open the lines of communications at all levels.

Chapter 6

Subcontractor's Bonding Checklist

Qualifying for a Subcontractor's Performance and Payment Bond

Establish a relationship with a professional surety agent or broker who:

- ☐ Is a specialist in contractor insurance and bonding
- ☐ Represents other subcontractors as well as general contractors for their surety needs
- ☐ Represents several surety companies

Demonstrate to the surety your capacity to perform by providing:

- ☐ Resumes of key people in your company
- ☐ List of successfully completed jobs
- ☐ Trade references
- ☐ Continuity plan for the business
- ☐ Firm's plans and objectives
- ☐ Explain the reasons for wanting the particular job

Establish a relationship with a Certified Public Accountant who:

- ☐ Is familiar with surety company financial statement requirements
- ☐ Represents other subs or general contractors

Demonstrate your firm's financial capacity by providing the surety with:

- ☐ Credit references
- ☐ Line of credit at bank
- ☐ Cost records
- ☐ Recent year-end financial statements audited by CPA, to include—
    - Auditor's Certificate
    - Balance Sheet
    - Profit and Loss Statement
    - Supplementary Schedules to include—
        - Work-in-process
        - Completed work
        - General and administrative expenses
        - Source and use of funds
        - Reconciliation of surplus

Subcontractor's Rights Under Prime Contractor's Payment Bonds

On Federal projects, subject to the Miller Act:

- ☐ If a first-tier subcontractor (one having a direct contractual relationship with the prime contractor) has not received payment within 90 days after payment is due, a suit may be filed under the payment bond. The suit cannot be filed, however, until the 90 days have elapsed, and must be filed within one year following the date that the last labor or material was furnished to the job.
- ☐ Second-tier subcontractors (those having no direct contractual relationship with the prime contractor) must give a formal, written notice to the prime contractor in order to file suit under the payment bond.
    - — The formal, written notice must be given to the prime contractor within 90 days after the last labor or material is supplied on the job.
    - — The notice must state the full name of the party with whom you have the contract, and the amount of the claim with substantial accuracy.
    - — Send the notice by registered mail to the prime contractor.
    - — Although not required, written notice should also be given to the surety.
    - — The suit to enforce the payment bond cannot be filed until after the expiration of 90 days from the date that the last labor was performed or the last material was supplied on the job.

REMEMBER, IF YOU FAIL TO GIVE NOTICE WITHIN 90 DAYS, AND FAIL TO FILE SUIT WITHIN ONE YEAR, YOUR RIGHTS UNDER THE BOND ARE VOID!

On state, county or municipal projects:

- ☐ Most states have statutes similar to the federal Miller Act covering these projects
- ☐ Consult your attorney on exact time limits and notice requirements for recovery under the payment bond in the particular jurisdiction

On all jobs, including private projects, subcontractors should protect their payment bond rights by:

- ☐ Determining if the project is bonded before signing a contract
- ☐ Obtaining a copy of the prime contractor's payment bond before the project begins
- ☐ Doing exactly what is required, within the time period stipulated, by the terms of the bond or the applicable state or federal statute should payment not be received when due

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[82] *Standard Accident Insurance Co. v. U.S. for the use of Powell*, 302 U.S. 442 (1938)

[83] *U.S. for the use of Sherman v. Carter*, 353 U.S. 210 (1957)

[84] *U.S. for the use of Pittsburgh-Des Moines Steel Co. v. MacDonald Construction Co., supra*

[85] *U.S. for the use of Bordello Consolidated, Inc. v. Markowitz Bros., Inc.*, 249 F.Supp. 610 (D.C. Guam, 1966)

[86] *U.S. ex rel. Southern G-F Co. v. Landis & Young*, 16 F.Supp. 832 (W.D. La., 1935)

[87] *U.S. for the use of General Accident Fire & Life Insurance Corp. v. Maguire Homes, Inc.*, 186 F.Supp. 659 (D. Mass., 1959)

[88] *F.D. Rich Co., Inc. v. U.S. for the use of Industrial Lumber Co., Inc.*, 417 U.S. 116 (1974)

[89] *Austin Elcon Corp. v. AVCO Corp.*, 590 F.Supp. 507 (W.D. Tex., 1984)

[90] 40 U.S.C. §270a(d)

[91] *Fago Construction Co.*, 162 F.Supp. 238 (D.C. W.D. N.Y., 1957) and *General Casualty Co. of America v. U.S.*, 205 F.2d 753 (5th Cir. 1953)

[92] *U.S. for use and benefit of Peevy v. Pensacola Construction Co.*, 257 F.Supp. 131 (W.D. Ark., 1966)

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[93] *United Pacific Insurance Co. v. United States*, 320 F.Supp. 450 (D. Ore., 1970)

[94] 26 U.S.C. §6659(a)(2). This section has since been amended and is now codified as 26 U.S.C. §6662(a)(2).

[95] *United Pacific Insurance Co. v. United States*, 320 F.Supp. 450 (D. Ore. 1970)

[96] *United States of America v. United States Fidelity and Guaranty Company*, xxxxx, F.Supp. xxxxx, Civil Action No. 84-JM-873 (D. Col., 1986)

[97] 26 U.S.C. §§6662(a)(2) and 6671(a)

[98] See 40 U.S.C. §270a(d), 26 U.S.C. §§6662(a)(s) and 6671(a)

[99] *Moyer v. U.S. for the use of Trane Co.*, 206 F.2d 57 (4th Cir. 1953)

[100] *U.S. for the use of Pomona Title Manufacturing Corp. v. Kelley*, 456 F.2d 148 (9th Cir. 1972)

[101] *United States for the use of Youngstown Welding and Engineering Co. v. The Travelers Indemnity Co. and A.S.C. Constructors Inc.*, Nos. 84-1673 and 84-1704 (9th Cir. October 21, 1986)

[102] *U.S. for the use of Jinks Lumber Co., Inc. v. Federal Insurance Co.*, 483 F.2d 153 (5th Cir. 1973)

[103] *U.S. of America for the use and benefit of General Electric Supply Co. v. Wiring*, 646 F.2d 1037 (5th Cir. 1981)

[104] *U.S. for the use of Jinks Lumber Co., Inc. v. Federal Insurance Co.*, 483 F.2d 153 (5th Cir. 1973)

[105] *U.S. of America for use and benefit of General Electric Supply Co. v. Wiring*, 646 F.2d 1037 (5th Cir. 1981)

[106] *Feld Roofing & Sheet Metal Corp. v. Seaboard Surety Co.*, 294 F.Supp. 112 (E.D. Va., 1968); see also: *Warrior Constructors, Inc. v. Harders Inc.*, 387 F.2d 727 (5th Cir. 1967)

[107] *U.S. for and on behalf of Delta Metals, Inc. v. R.M. Wells Co., Inc.*, 497 F.Supp. 541 (D. Ga., 1980)

[108] *United States for use and benefit of B's Co. v. Cleveland Electric*, 373 F.2d 585 (4th Cir. 1967)

[109] *J.S. and H. Construction Co. v. Richmond County Hospital Authority*, 473 F.2d 212 (5th Cir. 1973)

[110] *Rudneick & Co. v. Daniel et al.*, 357 F.Supp. 853 (N.D. Ill., 1973); *U.S. for use of Spike Voudouris v. Titan Pacific Construction Co.* (D.C. Wash. No. C79-131SC 1982)

[111] *U.S. for the use of Clark-Tana Paint Co.*, 397 F.2d 8 (4th Cir., 1968); *U.S. for the use of Jinks Lumber Co., Inc. v. Federal Insurance Co.*, 483 F.2d 153 (5th Cir. 1973)

[112] *U.S. for the use of T/N Plumbing & Heating Co. v. Fryt Construction Corp.*, 423 F.2d 980 (5th Cir. 1970); *U.S. for the use of Pembroke Steel Co. v. Phoenix General Construction Corp.*, 462 F.2d 1098 (4th Cir. 1972)

[113] 40 U.S.C. §270b(a)

[114] *Dravo Corp. v. Robert B. Kerris, Inc.*, 655 F.2d 503 (3rd Cir. 1981)

[115] *U.S. for the use of Honeywell, Inc. v. A&L Mechanical Contractors, Inc. and LeBlure Construction Co. National Surety Corp.*, 677 F.2d 383 (4th Cir. 1982)

[116] *U.S. for use of John P. Ahern Co., Inc. v. J.F. Whiting Contracting Co.*, 649 F.2d 29 (1st Cir. 1981); *A.B. Cooley v. Barten & Wood, Inc.*, 249 F.2d 912 (1st Cir. 1956)

[117] *U.S. for use of SBG Universal Builder's Supply, Inc. v. Fidelity & Deposit Co. of Maryland*, 475 F.Supp. 672 (E.D. N.Y. 1979)

[118] *U.S. for use of Olmstead Electric v. Neosho Construction*, 599 F.2d 930 (10th Cir. 1979)

[119] *U.S. for the use of Jos. T. Richardson v. E.J.T. Construction*, 453 F.Supp. 435 (D.C. Del. 1978); *U.S. for the use of H.T. Sweeney v. E.J.T. Const. Co., Inc.*, 415 F.Supp. 1328 (D. Del. 1976)

[120] 40 U.S.C. §270a(d)
However, the United States shall give the surety or sureties on such bond written notice, with respect to any such unpaid taxes attributable to any period, within ninety days after the date when such contractor files a return for such period, except that no notice shall be given more than one hundred and eighty days from the date when a return for the period was required to be filed under the Internal Revenue Code of 1954.

Section 6071 of Title 26 provides for the Secretary of the Treasury to prescribe the time for filing returns by regulations when not otherwise provided in Title 26. Treasury Regulations §31.6071(a)-1 provides that quarterly tax returns must be filed on or before the last day of the first calendar month following the period for which it is made.

[121] 40 USC §270b(a)

[122] *U.S. for the use of General Electric v. A.I. Lewis Construction Co.*, 375 F.2d 194 (1947); *U.S. for use of Altman v. Young Lumber Co.*, 376 F.Supp. 1290 (1974); *U.S. for use of John D. Ahern Co. v. J.F. White Contracting Co.*, 649 F.2d 29 (1st Cir., 1981)

[123] *U.S. for the use of Acme Transfer & Trucking Corp. v. Kaiser Inc*, 270 F.Supp. 215 (E.D. Wis., 1967); *Roane v. United States Fidelity & Guaranty Corp.*, 378 F.2d 40 (10th Cir., 1967); *United States for use of Fordham v. P.W. Parker, Inc.*, 504 F.Supp. 1066 (D. Md. 1980)

[124] *Bowden v. U.S. for the use of Malloy*, 239 F.2d 572 (9th Cir. 1956); *U.S. for the use of Bailey v. Freethy*, 469 F.2d 1348 (9th Cir. 1972)

[125] *Scholes, Inc. v. U.S. for the use of Moore Equipment Co.*, 295 F.2d 366 (10th Cir. 1961)

[126] *U.S. for the use of Hallenback v. Fleisher Engineering Construction Co.*, 311 U.S. 15 (1940); *U.S. for the use of Kelly-Mohrhusen Co., Inc. v. Batnode Co., Ltd.*, 457 F.2d 116 (7th Cir. 1972); *U.S. for Use of Hillsdale Rock Company v. Cortelyou and Cole, Inc.*, 581 F.2d 239 (9th Cir. 1978), *U.S. for use of Richardson, Inc. v. E.J.T. Construction Co.*, 453 F.Supp. 435 (D. Del., 1978), *U.S. for use of Greenwald Industrial Products Co. v. Barlow's Commercial Construction Co.*, 567 F.Supp 467 (D.C. D of C, 1983)

[127] *U.S. for use of Excavation Construction, Inc. v. Glenn-Stewart-Pinckney Builders and Developers, Inc.*, 385 F.Supp. 289 (D. Del., 1975)

[128] *U.S. for the use and benefit of Capital Electric Supply Co., Inc. v. C.I. Electrical Contractors, Inc.*, 535 F.2d 1326 (1st Cir. 1976)

[129] Also, see *Security Insurance Co. v. U.S. ex rel. Hoydis*, 338 F.2d 444 (9th Cir. 1964)

[130] *U.S. for the use of Soda v. Montgomery*, 253 F.2d 509 (3rd Cir., 1958)

[131] *U.S. for the use of Berkowitz v. Frankini Construction Co.*, 139 F.Supp. 153 (D. Mass., 1956)

[132] *Finley, Inc. v. Pilcher, Livingstone & Wallace, Inc.*, 314 F.Supp. 654 (D.C. S.D. Georgia, 1970); *General Insurance Co. of America v. U.S. for the use of Moore & Sons*, 406 F.2d 442 (5th Cir. 1969); *U.S. for the use of Bagnal Builders Supply Company v. United States Fidelity & Guaranty Co.*, 411 F.Supp.

1333 (D.C. D.S.C., 1976); *U.S. for use of Cane of New England, Inc. v. Diamond Construction, Inc.*, 582 F.Supp. 886 (D.C. Mass., 1984)

[133] *U.S. for the use of Wrecking Corp. of America v. Marden Corp.*, 406 F.2d 525 (1st Cir. 1969)

[134] *Ets-Horkin & Galvan, Inc. v. U.S. for the use of Pratt, Inc.*, 350 F.2d 871 (9th Cir. 1965)

[135] *U.S. for the use and benefit of Harvey Gulf International Marine, Inc. v. Maryland Casualty Co.*, 573 F.2d 245 (5th Cir. 1978)

[136] *Whittier v. Emmet*, 281 F.2d 24 (D.C. Cir., 1960)

[137] *U.S. for the use of Bailey-Lewis-Williams of Florida, Inc. v. Kiewit Sons Co. of Canada, Ltd.*, 195 F.Supp. 752 (D.C., 1961), aff'd 299 F.2d 930 (Dist. of Col. Cir. 1961); *U.S. for the use of Mitchell Bros. Truck Lines Corp. v. Jen-Mar Construction Corp.*, 223 F.Supp. 646 (D. Oregon, 1963)

[138] *U.S. for the use of Dillingham v. McCarty*, 174 F.Supp. 629 (D. Colo., 1959); *Limerick v. T.F. Scholes, Inc.*, 292 F.2d 105 (10th Cir. 1961)

Senator NUNN. Thank you very much, Mr. Sullivan and Mr. Bowen. I have a couple of questions for both of you.

One question is the problem that we now face unique or more dominant in the small and disadvantaged firms than it is in simply small businesses?

Mr. Bowen, what is your perception?

Mr. BOWEN. Senator, I feel it is more dominant with small disadvantaged firms for several reasons.

One of the problems with bonding in general is a lack of education on the part of the minority contractor as to how you gain access to the bond market. Most minority contractors are totally unfamiliar with how to go about obtaining a contract bond.

Normally they go to and deal with the insurance agent with whom they deal with in terms of getting their homeowners insurance or auto insurance. They have little understanding of how to approach an agent that specializes in writing contract bonds.

When they do find an agent who understands the contract bond market, generally that agent is not prepared to deal with the small contractor, particularly a small disadvantaged contractor.

Therefore, the small disadvantaged contractor is left out there without any avenues in which to gain access to these standard companies because most of the agents who represent the specialty companies that now participate in the Surety Bond Guarantee Program do not have access to the standard companies themselves.

So the disadvantaged contractor is totally perplexed as to how to gain access to the standard companies. He knows little about the preparation necessary to get the bond once he does gain access to an agent, and it is just a totally frustrating experience for these contractors.

I spend a great deal of my time traveling around the country making speeches to minority groups about what bonding is all about, then teaching them how to prepare their financial statements and prepare their bond package, and then finding an agent that is interested in even talking with them or interested in their broker business.

So it is a very frustrating experience for the small disadvantaged contractor in particular.

I would also say that problem exists with the small contractor in general. During my years with the SBA, our portfolio was 85 percent majority small contractors and 15 percent minority small contractors. So the small contractor in general has a problem with gaining access to the bond market.

However, there is a certain need to help the small disadvantaged contractor because of the fact that you have the SBA 8(a) Program setting contracts aside for those construction companies in their portfolio, and these contracts by law have to be bonded.

If a contract is set aside in excess of the SBA's statutory limit of $1,250,000, that 8(a) firm has nowhere to go to get a bond, let us say, for a $2 million contract because the specialty companies cannot write a bond in excess of the SBA statutory limit, or because of their limited capital base they are unable to write a bond for the small disadvantaged contractor.

That leads a contractor to the individual surety market or having to go and find an indemnitor, which normally is a majority contractor, which lends itself to abuse and all sorts of other problems which this Committee has dealt with in the past.

So there is a tremendous problem for the small disadvantaged contractor when it comes to the standard bonds being available to them. I would say in our State of Georgia I represent probably about 50 minority contractors, and I would say that only maybe two of them are able to say they are bonded through the standard market.

So there is a real problem, and that is my reason for supporting this bill today. It opens up the door to the small contractor so that they can get the benefit of a standard company and fortunately or hopefully be able to graduate into these standard companies' normal portfolio where they can bond, graduate from the SBA Program, graduate from the Set-Aside Programs and become a viable entity in the marketplace.

Senator NUNN. You anticipated to some extent my next question; that is, the graduation, the problem in 8(a) companies getting out of 8(a) and getting into the regular competitive world.

One of the features that we have tried to emphasize over and over again, which has more theory behind it than it does practical applications in many cases, is that we do not intend the 8(a) Program to be a permanent resting place for companies but rather a place that they can get business experience, and then go on to compete in the overall environment of a truly competitive world.

Now, is this bonding impediment that you have described one of the chief problems in getting out of 8(a) and competing in the normal course of business?

Mr. BOWEN. Senator, it is the chief problem. You have Federal, State and local laws that require bonds on most public expenditures for construction contract work. An 8(a) contractor that wants a job set aside for him has to obtain a payment performance bond.

If he does not have access to a standard market and has to use a specialty surety company which has a limited capital base and must use the SBA Guarantee Program, that contractor therefore cannot gain the large contract or gain access to bid on jobs in excess of that $1,250,000 limit.

The minority contractor spends 4 or 5 years in a Set-Aside Program. He is not being nurtured by the standard companies such that they can work with him, develop him and work with him in terms of being able to give him the bid bonds that he needs to bid on jobs outside of this Set-Aside Program.

Most of the 8(a) contractors unfortunately are forced to use individual sureties. They are forced to use the indemnification of majority contractors because SBA may set a job aside that is in excess of the contractor's ability to bond.

The contractor, once he gets the $2 million job, is going to ask for $3 million, $4 million or $5 million. He is using outside credit from someone else. He develops no individual bond credit of his own with the standard companies, so when it comes time for him to graduate he has no relationships with the bonding companies that he can then bid on work on a continuing basis.

Once he graduates, as it has been shown, I know, particularly in Georgia, most of the 8(a) contractors either have now disappeared, filed for bankruptcy or are performing contracts certainly a lot smaller than what they were receiving under the Set-Aside Program.

So the entire issue of bonding is the main focus point, in my opinion, for anything related to the 8(a) Program. There must be some measure of working with the bond companies and the 8(a) contractors such that you can get the necessary credit to bid and perform larger and larger projects.

I am not advocating that minority contractors just be given an unlimited amount of bonding, but I think there needs to be some measure of working with the minority contractor such that he can grow and become a viable part of this construction marketplace. Right now, that just does not exist.

Again, it is primarily related to the issue of bonding.

Senator NUNN. Thank you, Mr. Bowen.

Mr. Sullivan, what is your perspective now? You have heard the unique problems as Mr. Bowen has laid them out in his opinion as to minority contractors.

How does this compare with contractors who do not fit the definition of disadvantaged, but are nevertheless small?

Mr. SULLIVAN. ASA really does not have a position concerning minorities and this bill. We feel that the problem is not a race problem. It is a fact of being small, being un-educated about how to get a bond, and being high risk for the sureties.

I think it is an education program that has got to be addressed by the associations, the contractors, and the bonding companies. Everyone has to be part of the team working together for the common goal, and that is to provide bonding for small businesses, be it a minority or be it just a small business.

Senator NUNN. So you are saying the problem that Mr. Bowen is describing applies also to those who do not fit the same definition of disadvantaged?

Mr. SULLIVAN. Yes, sir.

Senator NUNN. If you are small and do not have the experience, if you do not have a track record, and if you have not worked with a large bonding company, you have a real problem?

Mr. SULLIVAN. Yes, sir.

Senator NUNN. You believe this 70 percent is going to be sufficient to attract the bonding companies to get involved in this with the waiver and letting them use their own pen, so to speak?

Mr. SULLIVAN. I would like to see it. I am sure they are going to let you know a little bit later what their opinion is.

But we feel that it would be a step forward.

Senator NUNN. Mr. Bowen, one other question. We have this provision about going to 90 percent guarantee. Some witnesses do not believe that is going to make any difference. They say that basically if 80 percent is not sufficient, that if it is too high a risk at 80, then they really are not going to do it at 90.

What is your perspective on that?

Mr. BOWEN. That is a tough question, Senator.

A 90 percent guarantee certainly would entice certain sureties to take a more active role in bonding small disadvantaged contractors because their exposure becomes only 10 percent.

I have discussed this with the representatives of the Surety Association, and they indicated they are prepared to write bonds for disadvantaged firms at 70 percent. I feel that if that is their position, I will support them in that position and take them at their word.

If they are willing to let the Government retain the 20 percent and not ask for and say they are going to write bonds for small disadvantaged firms, I certainly would like to see them step to the table and do what they say they are going to do.

I know the SBA's position probably relates to the fact that 90 percent is going to hurt their budget. They have had problems historically with not having enough funding to bond most of the contractors throughout the country, so the 90 percent guarantee, unless it is accompanied by an increased budget, I think would be detrimental to the program.

I certainly encourage the surety industry to do as much as it can to help the disadvantaged firm. If there are certain companies willing to take a 90 percent guarantee and make a concerted effort to bond the disadvantaged firms, I welcome that.

If the entity says they are going to write bonds for disadvantaged firms with only a 70 percent guarantee, I welcome that.

My interest is to see the marketplace open to the small disadvantaged contractor. I cannot foresee whether or not the industry is going to do what they say they are going to do. Historically, they have not participated in bonding the small disadvantaged firms, but they say that now they are prepared to step up and do a good underwriting job to protect both Government and their interests at 70 percent. I think if they are certainly prepared to make that effort, I am willing to stand and support them.

But at the same time, I would like to see the 90 percent provision left intact and find some sureties willing to work with SBA in coming up with something that could be acceptable both to the SBA and to the sureties.

Senator NUNN. Are you saying that if they really are going to do what they basically expressed an intention of doing under the 70 percent program with using their own pen that the 90 percent will be much less important?

Mr. BOWEN. Yes, sir.

Again, I hate to beat up on the industry for what they have not done, but certainly they have come a long way in the last few years in saying that they would work with the small disadvantaged firms.

I would like to see them do that. I would like to see them work with small minority-owned insurance agencies. I think that is an important component; that you must involve minority agents in this process.

If the industry is saying they are going to do this with a 70 percent guarantee, that certainly helps the Federal budget. There are, of course, a number of my clients who do not feel comfortable with the statement on the part of the industry, but I am one who believes that we should give them a chance to do what they say they are going to do.

Senator NUNN. How would minority insurance agents play a role in this 70 percent program?

Mr. BOWEN. Presently, Senator, there are very, very few, if not maybe any, minority-owned agencies that represent the standard surety companies. I feel that minority agents certainly are familiar with the problems that a minority contractor faces. I think that a minority agent should be involved in the bond process such that they can be advocates for bonding, such that they can help educate the minority contractor and also become a viable part of the insurance marketplace.

I think that if you are really going to try to attempt to solve this problem with bonding disadvantaged problems, and this problem has been ongoing since the program was created back in 1971, you have to create the marketplace that produces the bonds.

The insurance industry relies upon the American agency system; that is, they rely upon independent insurance agents to produce the bond for their companies. If you do not have enough agents out in the marketplace that are interested in helping the disadvantaged firms, those construction firms never can gain access to the Aetna door. They have to go through the local insurance agent.

Most of the agents that I work with in Atlanta are not able to take the time to work with a small disadvantaged firm because it takes the same amount of time to underwrite that small disadvantaged firm as it does the larger better contractors. They are typically going to spend their time with their better book of business.

I do not see them taking the time to nurture and work with the small disadvantaged firms with the same effort and energies they are going to use for their better clients.

So in my opinion, the industry has to work with small insurance agents, small minority-owned agents, to create the marketplace so that these disadvantaged contractors have somewhere to go through to get to the major bond companies.

Senator NUNN. Thank you, Mr. Bowen.

Mr. Sullivan, do you have anything else to add?

We appreciate both of you being here this morning. Thank you.

Next, we will have Mr. Lloyd Provost, president of the Surety Association of America, also representing the American Insurance Association, accompanied by Mr. John Curtin, Jr., president, National Association of Surety Bond Producers; Mr. Michael Lovendusky, counsel, American Insurance Association; and then Elaine Stevens, vice president, Transamerica Premier Insurance Co., California, representing the American Surety Association. She is accompanied by Mr. John Magnotti, Jr., executive vice president, the American Surety Association.

Any pronunciation of names that you would like to correct, we would be delighted for you to do so.

Is it Provost?

Mr. PROVOST. Provost.

Senator NUNN. Mr. Provost, why not lead off for us this morning.

STATEMENT OF LLOYD PROVOST, PRESIDENT, THE SURETY ASSOCIATION OF AMERICA, ISELIN, NJ, ON BEHALF OF THE AMERICAN INSURANCE ASSOCIATION, ACCOMPANIED BY MICHAEL LOVENDUSKY, COUNSEL, AMERICAN INSURANCE AGENCY

Mr. PROVOST. Mr. Chairman, my name is Lloyd Provost, and I am president of The Surety Association of America. The Surety Association is a trade association of more than 550 companies writing fidelity and surety bonds throughout the United States.

You have my statement, and I am not going to read it in its entirety, but I would like to stress a couple of things.

I am here today to support S. 2259, the Preferred Surety Bond Guarantee Program Act of 1988. The concept behind this bill was adopted by a subcommittee of The Surety Association in the early 1980s when we were asked to do so by SBA staff members to see if we could not find a way to get the standard companies more involved in the Bond Guarantee Program.

Under Plan B, the decisionmaking authority to place business in the program would be given to the surety company underwriter, with the SBA retaining audit authority. The surety company would retain all papers and merely report the bonds placed in the program to the SBA on a periodic basis.

Claims payments would also be handled in a similar manner.

Plan B was developed specifically with the standard surety companies in mind, and to be eligible for it companies would have to meet special requirements which we think will be adopted by the regulatory process. I have listed some of those in my paper. I will not go into them now unless you wish me to do so.

Plan B also will bring about the following desirable results.

It will switch the emphasis on SBA business from production to contractor performance. This will improve the loss experience in the program.

It will reduce the cost of the program to the Government by lowering the percentage of indemnity and increasing the percentage of premium paid to it.

It will reduce the cost of the program to the Government by insuring that the preponderance of claims work is done by company employees for which the surety receives no indemnity.

It will improve graduation results. Sureties in Plan B would be writing contract bonds outside of the program and hence would have the ability to graduate contractors from the program with a minimum of trouble.

It will procure a wider outreach for the program by the use of a network of professional surety bond producers.

It will ensure faster action on the needs of the contractors and the resolution of claims by eliminating the need for SBA approval of company actions.

It should be stressed that Plan B was not designed to replace the existing SBA program but rather to supplement it. If there is some concern about this point, The Surety Association would be willing to support a percentage limitation of the overall program that could be written in Plan B.

To the extent that the final legislation authorizing Plan B and the subsequent regulations implementing it track with the provisions I just outlined in the paper, we are confident that some of the major surety companies will be willing to enter into negotiations with the SBA to participate in the program.

I should emphasize the point that the decision to participate rests with the individual companies and will depend upon how the final program looks after we see the regulations.

A word of caution: Under Plan B, the Federal Government is in effect passing the power of committing Government funds to private companies. Obviously only private companies with impeccable credentials should be granted this trust.

Furthermore, should subsequent audits disclose that a company has violated this trust, the Government must be able to terminate that company's participation in Plan B upon very short notice.

Regarding the 90 percent guarantee which is proposed in the bill for losses incurred for bonds written for disadvantaged contractors, we have no real great objections to this provision, but I should point out that a 90 percent guarantee does greatly reduce the motivation for the companies to do a good job of underwriting in putting bonds in the program. This, I think, is the key to this question.

Granting bonds to unqualified contractors is the surest way to put a contractor into bankruptcy, so that actually we think that the smaller contractors need the advice and the help of the professional underwriters in order to set up their programs, their business plans, and so forth.

Consequently, if you wish to keep the 90 percent guarantee in the bill, we have no real objections to it but we think that Plan B and the passing of the power of pen to the companies would provide sufficient motivation for the standard companies to get involved.

Finally, Plan B is not going to change surety markets overnight. Unqualified contractors are not going to be able to obtain bonds under it, and we believe that to start you should have a Pilot Program which would be undertaken with one or two companies to see how the plan works in practice.

Plan B is a good-faith attempt on the part of The Surety Association to respond to the Administration's request to get the standard companies more involved in the SBA program.

Thank you for allowing me to testify.

[The prepared statement of Mr. Provost follows:]

STATEMENT OF LLOYD PROVOST BEFORE THE UNITED STATES SENATE COMMITTEE ON SMALL BUSINESS - APRIL 12, 1988

MR. CHAIRMAN, MEMBERS OF THE COMMITTEE. MY NAME IS LLOYD PROVOST AND I AM PRESIDENT OF THE SURETY ASSOCIATION OF AMERICA, WHICH IS A TRADE ASSOCIATION OF MORE THAN 550 COMPANIES WRITING FIDELITY AND SURETY BONDS THROUGHOUT THE UNITED STATES.

I AM HERE TODAY TO SUPPORT SENATE BILL 2259, THE PREFERRED SURETY BOND GUARANTEE ACT OF 1988. THE CONCEPT BEHIND THIS BILL, COMMONLY REFERRED TO AS PLAN B, WAS DEVELOPED BY A SUBCOMMITTEE OF THE SURETY ASSOCIATION IN THE EARLY 1980'S. IT WAS DONE SO IN RESPONSE TO A REQUEST WE RECEIVED FROM THE SBA TO TRY TO FIND A WAY TO INCREASE THE STANDARD COMPANIES PARTICIPATION IN THE SBA'S SURETY BOND GUARANTEE PROGRAM.

UNDER PLAN B, THE DECISION-MAKING AUTHORITY TO PLACE BONDS IN THE PROGRAM WOULD BE GIVEN TO THE SURETY COMPANY UNDERWRITER WITH THE SBA HAVING AUDIT AUTHORITY OVER EACH COMPANY PLACING BUSINESS IN IT. THIS IS SIMILAR TO THE RELATIONSHIP A SURETY COMPANY HAS WITH ITS PROFESSIONAL TREATY REINSURERS. THE SURETY COMPANY WOULD RETAIN ALL PAPERS AND WOULD MERELY REPORT THE BONDS PLACED IN THE PROGRAM TO THE SBA ON A PERIODIC BASIS. CLAIMS PAYMENT WOULD BE HANDLED IN A SIMILAR MANNER.

PLAN B WAS DEVELOPED SPECIFICALLY WITH THE STANDARD SURETY COMPANIES IN MIND AND TO BE ELIGIBLE FOR IT, THE COMPANIES WOULD HAVE TO MEET THE FOLLOWING REQUIREMENTS:

(1) MAINTAIN A CERTAIN UNDERWRITING LIMITATION ON THE U. S. TREASURY DEPARTMENT LIST OF ACCEPTABLE SURETIES. THE FIGURE WOULD BE DETERMINED BY REGULATION.

(2) AGREE TO ACCEPT A LOWER PERCENTAGE OF INDEMNITY AND PAY A HIGHER PERCENTAGE OF PREMIUM THAN THE NORMAL PROGRAM CALLS FOR. THIS SPLIT SHOULD BE SUCH THAT IT DISCOURAGES SURETIES FROM PLACING BAD BUSINESS IN PLAN B.

(3) AGREE THAT ONLY ITS NORMAL RATES FOR SURETY BONDS WOULD BE CHARGED FOR BUSINESS PLACED IN PLAN B.

(4) MAINTAIN A PERMANENT IN-HOUSE CLAIMS DEPARTMENT SATISFACTORY TO THE SBA.

(5) MAINTAIN FULLY STAFFED BRANCH AND HOME OFFICE UNDERWRITING DEPARTMENTS WHICH WRITE MOST OF THEIR CONTRACT BOND BUSINESS OUTSIDE OF THE SBA PROGRAM.

(6) AGREE THAT NO UNDERWRITING AUTHORITY WOULD BE VESTED IN ANY AGENT OR PRODUCER BUT RATHER GIVEN ONLY TO EMPLOYEES OF THE SURETY COMPANY, THEREBY ELIMINATING THE CONFLICT OF INTEREST WHICH EXISTS WHEN THE SAME PARTY PRODUCES AND UNDERWRITES BUSINESS.

PLAN B WOULD BRING ABOUT THE FOLLOWING DESIRABLE RESULTS:

(1) SWITCH THE EMPHASIS ON SBA BUSINESS FROM PRODUCTION TO CONTRACTOR PERFORMANCE. THIS WOULD IMPROVE THE LOSS EXPERIENCE IN THE PROGRAM.

(2) REDUCE THE COST OF THE PROGRAM TO GOVERNMENT BY LOWERING THE PERCENTAGE OF INDEMNITY AND INCREASING THE PERCENTAGE OF PREMIUM PAID TO IT.

(3) REDUCE THE COST OF THE PROGRAM TO THE GOVERNMENT BY INSURING THAT THE PREPONDERANCE OF CLAIMS WORK IS DONE BY COMPANY EMPLOYEES FOR WHICH NO SBA INDEMNITY IS INCURRED.

(4) IMPROVE GRADUATION RESULTS. SURETIES IN PLAN B WOULD ALL BE WRITING CONTRACT BONDS OUTSIDE OF THE PROGRAM AND HENCE WOULD HAVE THE ABILITY TO GRADUATE CONTRACTORS FROM THE PROGRAM WITH A MINIMUM OF TROUBLE.

(5) PROCURE A WIDER OUTREACH FOR THE PROGRAM BY USE OF A NETWORK OF PROFESSIONAL SURETY BOND PRODUCERS.

(6) INSURE FASTER ACTION ON NEEDS OF CONTRACTORS AND RESOLUTION OF CLAIMS BY ELIMINATING THE NEED FOR SBA APPROVAL OF COMPANY ACTIONS.

IT SHOULD BE STRESSED PLAN B IS NOT INTENDED TO REPLACE THE EXISTING SBA BOND GUARANTEE PROGRAM, BUT RATHER TO SUPPLEMENT IT. IF THERE IS SOME CONCERN ABOUT THIS POINT, THE SURETY ASSOCIATION COULD SUPPORT A PERCENTAGE LIMITATION OF THE OVERALL PROGRAM WHICH COULD BE WRITTEN IN PLAN B.

TO THE EXTENT THE FINAL LEGISLATION AUTHORIZING PLAN B AND THE SUBSEQUENT REGULATIONS IMPLEMENTING IT TRACK WITH THE PROVISIONS I HAVE JUST OUTLINED, WE ARE CONFIDENT THAT SOME OF THE MAJOR SURETY COMPANIES WOULD BE WILLING TO ENTER INTO NEGOTIATIONS WITH THE SBA TO PARTICIPATE IN THE PROGRAM. I SHOULD EMPHASIZE THE POINT THAT THE DECISION TO PARTICIPATE RESTS WITH THE INDIVIDUAL COMPANIES AND WILL DEPEND ON HOW THE FINAL PROGRAM LOOKS.

A WORD OF CAUTION. UNDER PLAN B THE FEDERAL GOVERNMENT IS IN EFFECT PASSING THE POWER OF COMMITTING GOVERNMENT FUNDS TO PRIVATE COMPANIES. OBVIOUSLY, ONLY PRIVATE COMPANIES WITH IMPECCABLE CREDENTIALS SHOULD BE GRANTED THIS TRUST. FURTHERMORE, SHOULD SUBSEQUENT AUDITS DISCLOSE THAT A COMPANY HAS VIOLATED THIS TRUST, THE GOVERNMENT MUST BE ABLE TO TERMINATE THAT COMPANY'S PARTICIPATION IN PLAN B UPON VERY SHORT NOTICE.

WE NOTE THE BILL BEFORE US PROPOSES TO PROVIDE SURETIES, INCLUDING PLAN B PARTICIPANTS, UP TO 90% INDEMNITY FOR LOSSES INCURRED OR PAID FOR BONDS WRITTEN FOR DISADVANTAGED CONTRACTORS. WHILE WE HAVE NO REAL OBJECTION TO THIS PROVISION, I SHOULD POINT OUT IT GREATLY REDUCES THE MOTIVATION FOR THE SURETIES TO DO A PROPER JOB OF UNDERWRITING. AS FAR AS THE STANDARD MARKET IS CONCERNED, I BELIEVE PLAN B WILL PROVIDE SUFFICIENT INDUCEMENT FOR SURETIES TO WRITE BONDS FOR DISADVANTAGED CONTRACTORS.

FINALLY, PLAN B IF ENACTED WILL NOT CHANGE SURETY MARKETS OVERNIGHT. UNQUALIFIED CONTRACTORS WOULD NOT BE ABLE TO OBTAIN BONDS UNDER IT AND WE BELIEVE AT THE START A PILOT PROGRAM SHOULD BE UNDERTAKEN WITH ONE OR TWO COMPANIES TO SEE HOW THE PLAN WORKS IN PRACTICE.

PLAN B IS A GOOD FAITH ATTEMPT ON THE PART OF THE SURETY ASSOCIATION TO RESPOND TO THE ADMINISTRATION'S REQUEST TO GET THE STANDARD COMPANIES MORE INVOLVED IN THE SBA PROGRAM.

THANK YOU FOR ALLOWING ME TO TESTIFY.

Senator NUNN. Thank you, Mr. Provost.

Mr. Curtin, did you have supplementary comments you would like to make?

Mr. CURTIN. I do, Senator.

STATEMENT OF JOHN J. CURTIN, JR., CHAIRMAN, GOVERNMENT AFFAIRS COMMITTEE, NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

Mr. CURTIN. For the record, my name is John J. Curtin, Jr. I appear here today in my capacity as chairman of the Government Affairs Committee of the National Association of Surety Bond Producers, an organization made up of over 650 professional surety bonds agents who provide bonds for contractors in public as well as private work.

I am the president of the Francis H. Curtin Insurance Agency, Inc., in Cambridge, MA, and my firm has been providing bonds for contractors for over 55 years.

To put my testimony in perspective and to give you an insight on my point of view, it may be useful for you to know that I currently serve as chairman of the National Construction Industry Council, a group comprised of over 22 of the major trade associations in the contracting industry. While I do not purport to speak for NCIC, my involvement with it should be evidence of my familiarity with the diverse segments of the construction industry.

I am also vice chairman of the Smaller Business Association of New England.

As an independent group of insurance agents and surety agents, the members of the National Association of Surety Bond Producers is not the least bit hesitant to take issue with The Surety Association of America when we find our positions at variance.

However, on this particular occasion we find ourselves fully in agreement with the position of Mr. Provost, the president of the SAA. We support passage of S. 2259 for all of the reasons that Lloyd has espoused in his testimony.

We also support SAA's caveat that the companies allowed to participate in Plan B should only be those with, as he put it, impeccable credentials.

Not all sureties are the same, and no one knows better than an agent who represents several. The strength of a surety is inexorably linked to its commitment to hire, train, and nurture quality personnel at both the underwriting and the claims handling level, its financial integrity and its tradition of commitment not only to the surety but to the advancement of a healthy construction community.

Having said that, I would like to beg the Committee's indulgence and elaborate a bit on the context of this bill. I would also like to submit some thoughts to the Committee for your consideration.

I read with interest the remarks of yourself, Senator, as well as those of Senator Weicker and Senator Bumpers in the Congressional Record. Each of you were eloquent in your advocacy of Plan B. There is nothing that was said with which I would take serious issue.

However, some of the phrases and the concepts that were used may not fully delineate the reasons why Plan B has been advanced and why The Surety Association of America and the NASBP are supporting it.

In all instances, a declarative statement was made to the effect that access to bonding is a detriment to access to Government contracting work. I would submit that bonding is supposed to be a detriment to easy access to Government work. By mandating the existence of bid bonds, the Government acknowledged that not all contractors possess equal qualifications.

Thus, the Miller Act passed in 1935 made it the business of sureties to separate the wheat from the chaff and state to the Government that those contractors who pass muster were indeed qualified to do the work.

This is the fundamental function of the bid bond. The Miller Act took the process a step farther and demanded that, having issued the bid bond or statement of qualification, if you prefer, the surety would further guarantee that the contractor would in fact perform the contract as well as pay those engaged by him to assist in that performance.

Consider then, if you will, the thought process of the surety in fulfilling its Miller Act responsibility. The surety does not certify a contractor on the basis of being somewhat sure. It does not say a contractor has a 50/50 chance of succeeding, an 80/20 chance of succeeding, or a 20 percent chance of succeeding.

The surety says that the contractor is qualified, and if he is not or if they were wrong in their judgment, then they will finish the job. Once the underwriter renders his judgment regarding a contractor, he is stuck with that judgment and he will pay dearly if he is wrong.

Therefore, the underwriter must be thorough in his analysis. If he is going to err, logic is going to dictate that he will err on the side of being conservative.

This point is not being made to argue the amount of SBA guarantee being proposed in Plan B. It is made in the hope that the record will be clear that surety is a judgment business, not a risk-taking business. Surety is based on what we know about what the contractor knows.

In essence, the Miller Act has said the Government has neither the expertise, the time, nor the inclination to assume the responsibility of qualifying contractors; therefore, Mr. Surety, you do it, and you had better be right or we will hang you with the cost of your mistake. It really is that simple.

If we do it correctly, we make money. If we do not, as has been the case over the past 4 years, we stand to take some major league losses.

In the late 1960s the Government proposed to spend billions of dollars on construction in urban areas over and above its normal level of spending. Part of that spending was clearly designed to rebuild cities and to provide jobs and opportunities to people living in the areas in which the work was to be done.

Hundreds of projects were designed and put out to bid, and many carried with them the requirement that a percentage of the work be done by minority contractors. Thus, the Government put up a big billboard that said opportunity available, apply here.

What the billboard did not say, however, was that only qualified opportunists need apply, the qualification being that surety bonds were required. When those aspirants who received rejection slips from sureties then approached the Government and complained that there was an impediment existing, prohibiting their taking advantage of the opportunity presented, we saw the birth of the Surety Bond Guarantee Program.

It is not my intent in making the point to be either critical or pendantic. What I am trying to make clear is that neither the Government nor the sureties recognized that they were actually working at cross-purposes in a sense.

The Surety Bond Guarantee Program was a pragmatic attempt at bridging the gap between Government's desire to help its constituents, the mandate to sureties to screen out unqualified contractors, and the reality that the goal of the Government could only be achieved by sureties providing something less than an unqualified judgment they were constituted to provide.

The SBG Program is the essence of pragmatic compromise. Government introduced the requirement that the surety take risk. The surety said it could not assume that risk without something to mitigate it because they were not in the business of taking risk. The Government, ergo, took the major part of the risk back.

18 years after the establishment of the program we sit here discussing an expansion of the program with a bit less intensity in terms of the dichotomy of the late 1960s but with an expanded listing of those to whom the Government is advertising opportunity. To the minority contractor we have added women business enterprises, disadvantaged business enterprises; indeed, anyone who qualifies as a small business.

Once again, I am not being critical. It is important to me, however, and to the members of the National Association of Surety Bond Producers that the Government understand that the premise of the surety practitioner has not changed. We will respond to our mandate to the best of our ability. We will qualify on behalf of the Government those we consider capable. The price they pay is irrelevant to our judgment. Their expertise, organization, experience, business skills, and the ability to finance their undertakings are relevant. Anything beyond what is relevant takes us out of the business of rendering judgments and puts us into the business of evaluating and accepting risk, something for which we are neither trained nor inclined.

My final point has to do with the discussions in the Congressional Record regarding what Plan B will accomplish. It was said that Plan B would add capacity to the program. That is a bit misleading, in that the capacity of the Surety Bond Guarantee Program is a function of two items. Primary capacity is determined by what Congress appropriates for the program, not by how many sureties participate in the program.

The capacity increase in Plan B will be directly affected, therefore, by the percentage of appropriated funds dedicated to the guarantee to the surety versus what risk the surety assumes and by recycling appropriated funds used for guarantees once the underlying obligations for which they are allocated have been satisfied.

If the purpose of Plan B is to expand the number of sureties participating, that end will obviously be accomplished, as will, as Mr. Provost points out, the facility for the graduation of program contractors into the normal surety marketplace.

Finally, it was stated in the record that the cost of handling cases in the program is in excess of what a normal surety could bear. No one again knows that better than an agent because the burden of that cost falls disproportionately on us.

Thus, Plan B makes sense as a vehicle that will allow broader agent participation. The byproduct of that will be greater willingness on the part of more agents to reach out to the target marketplace. This should help contractor aspirants because they will receive much better service, in my opinion.

In addition, it will enhance the prospects of graduation because of the variety of sureties available to the agents that would be participating.

I should also point out that many of us in the NASBP, particularly those of us who understand what the significance of the small business community is to the growth of our economy, do not believe that the current aversion to small contractors is in the best interest of surety or the construction industry. Many of us are actually searching for ways to accommodate the smaller contractor, be they he or she, black, brown, yellow, red or purple.

As a group, we really do not care about race, religion, sex, country of origin; what we really care about is an answer to the question, can they do the job. After that, the only thing we care about is the color of their money.

Some sureties argue that it is too expensive to develop and nurture small contractors. There are others who consider that view very shortsighted. Little guys become big guys, and client loyalty is stronger if developed early in the growth of the client. That view may not square with the Harvard Business School of the world, but it has stood me in good stead for 22 years.

There are emerging markets for smaller contractors, and there are enlightened established sureties who are on the brink of developing programs for small contractors. To ignore the age of the entrepreneur even for surety is folly. Many of us will develop this marketplace regardless of what happens with Plan B.

I appreciate your forebearance.

Senator NUNN. If I understand what I believe I heard both of you say, you are basically saying that this legislation is a step forward? It will help, but this is a hard, cold, tough businessworld and we should not expect miracles; is that right?

Mr. PROVOST. Yes, sir.

Mr. CURTIN. I agree.

I think that one of the things that some people just do not seem to understand is that the contracting business is a business with the same risks and pitfalls, perhaps even greater risks and pitfalls, than practically any other business in the country. I mean, the failure rate of contractors historically has been among the highest of any business group.

Contrary to popular opinion, it is a capital-intensive business, so that the phrase "disadvantaged 'becomes somewhat of a funny term in my view because anybody starting out in the construction industry without capital and without the knowledge to go forward and prosecute the business for profit is in fact disadvantaged by all the people who have already gone through the process and are already there.

That is a competitive reality.

Senator NUNN. Thank you.

Ms. Stevens.

STATEMENT OF ELAINE STEVENS, VICE PRESIDENT, THE AMERICAN SURETY ASSOCIATION, AND ASSISTANT VICE PRESIDENT, TRANSAMERICA PREMIER INSURANCE CO., ORANGE, CA, ACCOMPANIED BY JOHN MAGNOTTI, JR., EXECUTIVE VICE PRESIDENT, THE AMERICAN SURETY ASSOCIATION

Ms. STEVENS. Thank you, Mr. Chairman. I am Elaine Stevens. I am vice president of the American Surety Association. I am assistant vice president of Transamerica Premier Insurance Company out of Orange, CA, and I manage the Surety Bond Program.

Transamerica Premier is the largest producer in the Small Business Administration's Surety Bond Guarantee Program. The American Surety Association was organized in 1980. It unites over 150 surety companies, general agents, attorneys, and contractors. The primary task of the association since it was organized has been to assure the continued availability of surety bonds for small and minority contractors.

All of our members participate to a greater or lesser degree in the Small Business Administration's Surety Bond Guarantee Program. This program, since its inception in the early 1970s, has been instrumental in providing thousands of jobs in the construction industry and in providing a dependable vehicle for thousands of small emerging contractors to obtain necessary bonding at reasonable rates.

If you have no objection, I would like to comment briefly on some of the conceptual aspects of the discussion draft of the bill to amend the Small Business Investment Act of 1958. Following this, myself and some of my colleagues who are behind me would be pleased to answer any questions you may have about the operation of the Small Business Administration's Surety Bond Guarantee Program as we see it, or the potential impact of the legislation you are proposing to encourage the standard surety firms to participate in the program.

We recommend strongly, Mr. Chairman, that you reconsider the provision in the bill which sets up different guarantee levels for firms owned by socially and economically disadvantaged individuals and other small businessmen.

As far as our members are concerned, the bonding process is totally and absolutely nondiscriminatory. The critical factor in the underwriting process is whether or not the contractor is qualified for the job. Ethnic backgrounds are not and have never been a consideration in bonding.

There is a guarantee floor, currently 80 percent of the face value of the bond, under which our surety companies cannot rationally bond high-risk contractors; therefore, providing a 90 percent guarantee for a subset of small businesses serves no useful purpose and may well convince agents as well as other small businesses that the program is designed only for firms owned by socially and economically disadvantaged contractors.

We have worked for many years to insure that the program is available equally to all small and disadvantaged contractors with the certain knowledge that our underwriting procedures are being applied fairly and without bias across the entire group.

Unless the Federal Government provides a 100 percent guarantee, which would contradict the very reason for surety underwriting, no company will issue what it considers to be a bad bond, no matter what the guarantee. A bad bond simply means a certain loss.

Further, the underwriting process is not sufficiently precise to be able to ratchet-up one additional degree of risk for each additional degree of added guarantee.

With regard to minority contractors, I would like to point out that many of our agents carry substantial numbers of minority contractors in their portfolios. As an example, my colleague, Mr. Shaver, who is here and represents R. B. Brown and Associates, writes about one-third of his total book in the SBA Surety Bond Guarantee Program. Of that, over 40 percent are minority-owned firms. Mr. Shaver also has minority firms in his standard book.

Other agents in our association have similar records.

Senator Nunn. What do you mean by "in his standard book'?

Ms. Stevens. With the Hartfords, USF&Gs, and so forth, I believe he represents INA, which is one of his largest surety companies, and the standard Transamerica Insurance Company, of which we are a part of the same group.

Senator Nunn. As opposed to specialty?

Ms. Stevens. Right, as opposed to specialty, the conventional marketplace.

My company, Transamerica Premier, has for several years been working with the States of Maryland and Pennsylvania to establish Surety Bond Guarantee Programs similar to the Federal program, except that they are designed exclusively for the minority contractor.

The Maryland program, the Maryland Small Business Development Financing Authority Surety Bond Guarantee Program, is in place, and we have issued a number of bonds through that program.

The Pennsylvania program, the Pennsylvania Minority Business Development Authority Surety Bond Guarantee Program, is in the process.

We respect and support your efforts to make this program more viable and to encourage additional surety firms to participate. As I have stated, we do not agree that the most effective method for reaching that goal is the adjustment of guarantee levels beyond a certain level.

What could be the most important and effective provision of the bill, on the other hand, is the amendment contained in section

301(2)(b) of the proposal. This provides that, "sums obligated from the fund for the guarantee of a bond shall be deobligated upon receipt of the surety's notice of release by the Administration, and such funds shall become available for subsequent bond guarantees under the program."

This, in our opinion, hits at the heart of the problem, the availability or lack of guarantee authority. Shutdowns due to lack of guarantee authority have been a constant and nagging problem in the program. Shutdowns have hurt the very contractors that we are trying to help.

The program was out of guarantee authority in 1986, as an example, and shut down for virtually the entire fiscal fourth quarter, which is the busiest time of the year in the construction industry. Many of our contractors, especially those in the northern States, rely on jobs they get in September to carry them through the winter months.

We saw the impact of this shutdown reflected in many of the contractors' year-end or interim financial statements, which showed little or no profit. Most of them managed to keep afloat, barely.

Periodic bonding is what frustrates contractor and surety alike, and solving this one problem will in large measure provide the additional impetus necessary to expand the bonding base for all small and disadvantaged businesses.

Thank you, Mr. Chairman.

[The prepared statement of Ms. Stevens follows:]

TASA
THE AMERICAN SURETY ASSOCIATION
1350 New York Ave. N.W., Suite 615, Washington, D.C. 20005 • (202) 393-1780

STATEMENT BY
THE AMERICAN SURETY ASSOCIATION
FOR THE
SENATE COMMITTEE ON SMALL BUSINESS
APRIL 12, 1988

Mr. Chairman, I am Elaine Stevens, a Vice President of the American Surety Association. I am an Assistant Vice President of Transamerica Premier Insurance Company in Orange, California, and manage the surety bond program. Transamerica Premier is the largest producer in the Small Business Administration's Surety Bond Guarantee program. With me at the table are John Magnotti, the Executive Vice President of the American Surety Association and Thomas Fairfield, a Past President of the American Surety Association and President of the Fairfield Company, a general agency. Just behind us are Kathy Zack, President of the American Surety Association and a principal in Cornish, Zack, Hill & Associates, a general agency, and Michael Shaver, a principal in R.B. Brown and Associates, also a general agency.

The association was organized in 1980. It unites over 150 surety companies, general agents, attorneys and contractors. The primary task of the association since it was organized has been to ensure the continued availability of surety bonds for small and minority contractors.

All of our members participate to a greater or lesser degree in the Small Business Administration's Surety Bond Guarantee program. This program, since its inception in the early 1970s, has been instrumental in providing thousands of jobs in the construction industry and in providing a dependable vehicle for thousands of small, emerging contractors to obtain necessary bonding at reasonable rates.

If you have no objection, Mr. Chairman, I would like to comment briefly on some of the conceptual aspects of the Discussion Draft of the bill to amend the Small Business Investment Act of 1958. Following this, my colleagues and I will be pleased to answer any questions you or the other members of the committee might have about the operation of the Small Business Administration's Surety Bond Guarantee program, as we see it, or the potential impact of the legislation you are proposing to encourage the standard surety firms to participate in the program.

We recommend strongly, Mr. Chairman, that you reconsider the provision in the bill which sets up different guarantee levels for firms owned by socially and economically disadvantaged individuals and other small businessmen. As far as our members are concerned, the bonding process is totally and absolutely non-discriminatory. The critical factor in the underwriting process is whether or not the contractor is qualified for the job. Ethnic backgrounds are not, and have never been, a consideration in bonding.

There is a guarantee floor, currently 80 percent of the face value of the bond, under which our surety companies cannot rationally bond high-risk contractors. Therefore, providing a 90 percent guarantee for a subset of small businesses serves no useful purpose and may well convince agents as well as other small businesses that the program is designed only for firms owned by socially and economically disadvantaged contractors. We have worked for many years to ensure that the program is available equally to all small and disadvantaged contractors, with the certain knowledge that our underwriting procedures are being applied fairly and without bias across the entire group.

Unless the federal government provides a 100 percent guarantee, which would contradict the very reason for surety underwiting, no company will issue what it considers to be a bad bond no matter what the guarantee. A bad bond simply means a certain loss. Further, the underwriting process is not sufficiently precise to be able to ratchet up one additional degree of risk for each additional degree of added guarantee.

With regard to minority contractors, I would like to point out that many of our agents carry substantial numbers of minority contractors in their portfolios. As an example, Mr. Shaver of R. B. Brown and Associates, with me here, writes about one third of his total book in the SBA's Surety Bond Guarantee program. Of that, over 40 percent are minority-owned firms. Mr. Shaver also has minority firms in his standard book. Other agents in our association have similar records.

My agency, Transamerica Premier, has for several years been working with the States of Maryland and Pennsylvania to establish surety bond guarantee programs similar to the federal program, except that they are designed exclusively for minority contractors. The Maryland program, the Maryland Small Business Development Financing Authority Surety Bond Guarantee Program, is in place; while the Pennsylvania program, the Pennsylvania Minority Business Development Authority Surety Bond Guarantee Program, is in process.

We respect and support your efforts to make this program more viable and to encourage additional surety firms to participate. As I have stated, we do not agree that the most effective method for reaching that goal is adjustment of guarantee levels beyond a certain level. What could be the most important and effective provision of the bill, on the other hand, is the amendment contained in Section 301 (2) (b) of the proposal. This provides that, "Sums obligated from the fund for the guarantee of a bond shall be deobligated upon receipt of the surety's notice of release by the Administration and such sums shall become available for subsequent bond guarantees under the program." This, in our opinion, hits at the heart of the problem -- the availability, or lack, of guarantee authority.

Shut downs due to a lack of guarantee authority have been a constant and nagging problem in the program. Shut downs have hurt the very contractors we are trying to help. The program was out of guarantee authority in 1986, for example, and shut down for virtually the entire fiscal fourth quarter, the busiest time of the year in the construction industry. Many of our contractors, especially those in the northern states, rely on jobs they get in September to carry them through the winter months. We saw the impact of this shutdown reflected in many of the contractor's year-end or interim financial statements, which showed little or no profit. Most of them managed to keep afloat, barely. "Periodic bonding" is what frustrates contractor and surety alike, and solving this one problem will in large measure provide the additional impetus necessary to expand the bonding base for all small and disadvantaged businesses.

Thank you, Mr. Chairman. We would be pleased to answer any questions the committee might have.

Senator NUNN. Thank you very much.

You clearly do not favor the 90 percent, going from 80 to 90 percent?

Ms. STEVENS. I see no need for it as far as having any impact on the surety companies' participation for the socially and economically disadvantaged contractors.

Senator NUNN. You mentioned there has never been discrimination or any discrimination on an ethnic basis. How about on a sexual basis?

Ms. STEVENS. Not that I am aware of. Any accounts that are submitted to me at home office—I have no idea of sex or ethnic background. I do not even look at the names on them. I just look at their prior experience and their financial abilities. I do not care what race or sex runs or owns the company.

Senator NUNN. Now, you are in favor of letting companies use their own pen and having the 70 percent guarantee; is that right?

Ms. STEVENS. Yes, we are, to an extent. Yes. We feel that it should be monitored by the individuals at the SBA as to what companies can participate in the program.

We feel that should be established by the individuals that are running the SBA Program, as they are probably the most familiar with the surety companies that deal with them.

Senator NUNN. You are speaking both for specialty companies and standard companies in that respect?

Ms. STEVENS. Whichever companies would qualify under whatever guidelines they outlined, yes.

Senator NUNN. Your association represents specialty companies?

Ms. STEVENS. Yes. We have basically specialty companies within it, although the agencies and the agents who are members of our association are not all representatives of specialty companies. They also represent the conventional surety markets and the standard markets.

Senator NUNN. I am just wondering if you are speaking, though, for some specialty companies?

Ms. STEVENS. Yes, I basically am speaking for the specialty markets.

Senator NUNN. Is that for all of them or some of them?

Ms. STEVENS. That would be for the members of the American Surety Association. I cannot speak for the others.

Senator NUNN. What percentage of the specialty companies do belong to your association?

Ms. STEVENS. Well, there are a lot of specialty companies out there. Not all of them participate in the SBA Program.

Senator NUNN. That is to whom I have reference.

Ms. STEVENS. Of the ones that participate in the SBA Program, probably I would say about 70 to 80 percent participation comes from members of our association.

Transamerica Premier, my own company, writes approximately 40 percent of all of the SBA-guaranteed bonds at this time nationwide. So right there, we do represent a very large majority.

Senator NUNN. If the standard companies come into this program, if it really works, if it works even better than anyone anticipates, do you believe that that is going to have a severe impact on the specialty companies, or do they have plenty of business and they are not concerned about it?

Ms. STEVENS. I believe there is plenty of business out there. I think where it could hurt is if we do not get adequate funding for the program, where we have limited funding. That is why we support the revolving fund.

Senator NUNN. Right.

Ms. STEVENS. We have run out of funds for a couple of years. We managed to get through last year with adequate funds.

But, no, I believe there is plenty of business out there. I do not think it will hurt the specialty companies at all with the standards, if they do decide to participate to any extent in the program. We encourage it.

Senator NUNN. Some have suggested the large part of the problem with small firms obtaining bonding can be traced to the way agents are compensated on the basis of a percentage of a value of the bond.

Given that it takes almost as much, sometimes even more, time to underwrite a small bond as it does a large bond, do we really have incentives for small bonds to be written and small companies' needs to be taken care of?

I would open that for anyone who would like to address it.

Mr. CURTIN. The compensation that an agent receives by virtue of being a percentage of the fee charged by the surety will vary. Obviously, looking at the numerical aspect of it, if you do write smaller bonds, you make less money.

I think if you take the agent in context as the marketing arm of the surety industry, the smarter agents in the communities are going to be seeking out the smaller emerging contractor.

I have been in the business for 22 years. I do not want to worry about my father's big clients because they are all dying. What I want is to develop the people that are going to be like my dad's big clients 20 years down the road. We are out there looking for good quality talented people.

I am very sincere when I say that I do not care about color or anything like that. I will eat the risk of the cost, I will bear the burden of the cost to develop a piece of business over a period of time. I think that is my responsibility. I think that is my role.

I do not really need an incentive coming from any other place other than the normal sphere of business. I also get an override if I write profitable business from the companies I represent. So there is a kicker at the end of the year. I lose that if I write business that creates losses.

So in that sense, Senator, I do not think that the incentive is necessarily there to develop it beyond just prudent, aggressive business practices.

Senator NUNN. Ms. Stevens, do you have any comments on that?

Ms. STEVENS. I believe in the specialty field most of our agents have set up their operations whereby they can efficiently, cost efficiently, handle the smaller contractors. This is what we have been designed to handle. This is what the agents in our company have been writing for many years.

With the SBA's recent use of the bonding lines, it has helped considerably to expedite the paper flow within the SBA Program. I believe, as I mentioned, that most of our agents have gotten this down to a fine science, that they can get the paper flow through the office very quickly.

Yes, initially to underwrite a small contractor takes just as much work as a large contractor. We have one particular contractor in the Nevada area that got his first bond with us several years ago. He is now doing in excess of $40 million a year. He is bidding on a $100 million renovation to a major Nevada hotel.

We like success stories like that, so our agent is willing to work with the small contractor because some day he may be the big guy doing the $100 million projects. Then again, there are some that will never grow, and we realize this; but they are good, stable little contractors, and once the account is set up, other than reviewing it every 6 months or so, it runs very smoothly and is nominal work.

Mr. CURTIN. Senator, by the way, the way the premium rate structure goes, it is a descending scale downwards, the commission scale goes with it. I would much rather write 10 $2.5 million bonds any day of the week than one $25 million bond. I am going to make more money that way.

Senator NUNN. Because you get more on the first part of the——

Mr. CURTIN. You have that graduated scale, and it is loaded at the top, or loaded actually at the bottom, at the lower end of the contract spectrum.

Senator NUNN. So you get a higher percentage of the first $1.5 million.

On the paperwork, how big a problem, Mr. Provost and Mr. Curtin, are the SBA paperwork requirements now? In other words, when you use your own pen and go down in terms of from 80 to 70, why is that additional incentive for you?

Mr. PROVOST. Because each company has their own standardized forms and a way of doing business. Under the existing SBA Program, you have to use their paper, you have to use their forms.

So in effect you are taking the underwriter out of his ordinary flow of work and requiring him to get involved with other type of forms which may not necessarily include all the information that his company or her company may want.

Senator NUNN. It is just not worth it; right?

Mr. PROVOST. Yes, sir. If you have a contract with a $50 million bond on your left hand, and you have one on your right hand for a $500,000 bond with a whole lot of different paperwork, including the possibility of having to sit down and work with the contractor and the agent you know which one you are going to spend your time on.

So that is part of the reason why the companies backed away from the program.

Mr. CURTIN. The National Association of Surety Bond Producers, for your information, develop a computerized file system that we are trying to use to standardize everything in the business. We are a few years away from getting to the point of standardization, but we have introduced a couple of forms into the process that have been accepted widely by the companies. As that thing spreads, the cost of doing business should reduce for all of us over time.

Senator NUNN. Mr. Lovendusky, I have not asked you any questions. Do you have anything you would like to add to this?

Mr. LOVENDUSKY. Just briefly, Mr. Chairman, the American Insurance Association commends the Chairman and the Committee for undertaking the improvements to this legislation.

The association represents 183 of the largest property casualty insurance companies in the Nation, many of which write fidelity and surety bonds.

I want to associate the AIA with the comments of Mr. Provost and the Surety Association and assure the Committee that the AIA will bring the improvements of this legislation, once enacted, to the attention of the right people in our member companies.

Senator NUNN. You think it will help?

Mr. LOVENDUSKY. Yes.

Senator NUNN. Thank you all for being here. We appreciate your testimony before the Committee.

Thank you.

Our next panel, Mr. Edwin T. Holloway, Associate Administrator for Finance and Investment, Small Business Administration. He is accompanied by Mr. Robert G. Lineberry, Deputy Associate Administrator for Investment, and Mr. Howard F. Huegel, Director of the Office of Surety Guarantees.

Gentlemen, we are glad to have you this morning.

Mr. Holloway, would you like to lead off?

STATEMENT OF EDWIN T. HOLLOWAY, ASSOCIATE ADMINISTRATOR FOR FINANCE AND INVESTMENT, U.S. SMALL BUSINESS ADMINISTRATION, WASHINGTON, DC, ACCOMPANIED BY ROBERT G. LINEBERRY, DEPUTY ASSOCIATE ADMINISTRATOR FOR INVESTMENT; AND HOWARD F. HUEGEL, DIRECTOR, OFFICE FOR SURETY GUARANTEES

Mr. HOLLOWAY. Good morning, Mr. Chairman. Thank you for the opportunity to be here and present our testimony this morning.

As you indicated, I am accompanied by Mr. Robert Lineberry and Mr. Howard Huegel from the Small Business Administration.

I am pleased to say that SBA favors the authorization and implementation of a preferred surety program and in 1987 proposed legislation for that purpose. S. 2259, while it would provide the authority sought by SBA, also contains other provisions which SBA believes to be unnecessary and are counter to the streamline guarantee approval objective of preferred sureties.

The most objectionable of these is the proposed requirement that SBA increase its guarantee on bonds for small contractors deemed socially and economically disadvantaged to 90 percent from the present 80 percent on individually approved cases or the proposed 70 percent for preferred sureties.

Our full statement explains the underwriting and administrative reasons why we believe this requirement would not meaningfully increase availability of surety bonds to qualified disadvantaged contractors.

We note that minority contractors presently receive approximately 25 percent of the total program benefits annually in terms of both numbers and dollar value of bonds guaranteed by SBA, which we feel is about proportional to their representation among all small contractors.

Senator NUNN. Could you say that again? I did not get it.

Mr. HOLLOWAY. Yes, sir.

We note that minority contractors presently receive approximately 25 percent of the total program benefits annually in terms of both the number and the dollar value of bonds guaranteed by SBA.

Senator NUNN. About 25 percent of the guaranteed bonds——

Mr. HOLLOWAY. Go to minorities.

Senator NUNN. Are you talking about the number of bonds, or are you talking about the loss of Government funds based on defaults and problems?

Mr. HOLLOWAY. I am talking about, Mr. Chairman, the number of bonds and the dollar value of those bonds.

Senator NUNN. Gross, when they are going in?

Mr. HOLLOWAY. Going in.

Senator NUNN. What about the loss? Do you have those figures?

Mr. HOLLOWAY. I do not have those figures, Mr. Chairman. If they are available, I would be pleased to submit them for the record.

Senator NUNN. Thank you.

[Material follows:]

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FUND CODE: 73X4156                           SURETY BOND GUARANTEE                                     REPORT ID: SBG-413
                                             SURETY BONDS IN DEFAULT                                     RUN DATE: 04/20/88
                                            MINORITY REPORT BY REGION                                    RUN TIME: 09:29:32
                                                 AS OF 03/31/88                                              PAGE:    11

  AGENCY WIDE TOTALS                                     NBR OF        TOTAL NET     Total Net          % of Net
                                                         NOTICES         PAID        Paid - Minorities  Paid-Minorities
                             MINORITY CODE                  21        2,984,264
  FY TO DATE                       0                                     82,011
                                   1                         8          528,831
                                   2                        10          474,405
                                   3                         6          124,576
                                   4
                                   5                        17        1,098,462
                                   6
[redacted]                                                                        5,302,373          36.64
                                                                          9,824
                                   8
                                   9
                             FY TO DATE TOTAL              192       14,470,911-

                                                            61        5,069,883
  FY 1987                          0                         3          393,720
                                   1                        17          409,285
                                   2                        16          759,036
                                   3                         8           39,774
                                   4
                                   5                        45        2,080,885
                                   6
[redacted]                                                                                          36.91
                                                             1                    8,752,583
                                   8
                                   9
                             FY 1987 TOTAL                 472       23,706,890-

                                                           134        2,700,414
  FY 1986                          0                         2          117,606
                                   1                        11          276,602
                                   2                        36          548,195
                                   3                         8           36,270
                                   4
                                   5                        48          993,894
                                   6
[redacted]                                                                        4,843,646.         37.57
                                   8                                    168,665
                                   9
                             FY 1986 TOTAL                 736       12,890,579-

                                                         1,046       28,962,555
  12/76 TO DATE                    0                        71        2,075,044
                                   1                       161        4,160,709
                                   2                       321        7,561,647
                                   3                       128        2,724,150
                                   4
                                   5                       702       16,578,716
                                   6
[redacted]                                                                        63,784,641         31.77
                                                                          9,824
                                                             1        1,711,996
                                   8                        68
                                   9
                             12/76 TO DATE TOTAL         8,370      200,748,276-



REPORT SBG413   COMPLETED
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	VET_	Enter 1-digit organization code. Valid Values are: 1 = No 2 = Viet Vet 3 = Other Vet EXAMPLE: Type 2
	WOMAN_	Enter 1-digit Woman owned code. Valid values are: 1 = No 2 = Yes EXAMPLE: Type 1
	MIN_	Enter the one digit SBA Minority Code associated with the contractor company. Valid values are: 0 = Black 1 = Puerto Rican 2 = American Indian 3 = Spanish American 4 = Asian 5 = Eskimo and Aleut 6 = Undetermined 7 = Other - Including White 8 = Multi-group
	8(a)_	Enter 1-Digit 8(a) Company Code. Valid values are: 1 = Company is not in 8(a) Program 2 = Company is in 8(a) Program
	MA ASST_	Enter 1-digit Management Assistance code. Valid values are: 1 = No 2 = Requested 3 = Receiving 4 = Received EXAMPLE: Type 4
13. NUMBER OF APPLS		Displayed on Changes and Inquires the number of applications submitted by the contractor.
14. APRVD CONTS		Displayed on Changes and Inquiries the number of approved contracts this contractor has had approved.

Mr. HOLLOWAY. SBA also believes that the proposed requirement that the Inspector General audit all participating sureties annually would impose an unnecessary administrative burden. SBA presently has the authority to audit participating sureties at all reasonable times and to establish and monitor their compliance with acceptable underwriting standards, claimshandling practices and loss ratios.

SBA also believes its existing separate size standard for surety bond guarantee eligibility is easily understood and administered by both surety agents and SBA personnel.

Based on the total number and average dollar amount of bonds being guaranteed, it is also allowing us to focus program human and budget resources on the smallest contractors where the need for bond guarantees is greatest.

Accordingly, we recommend that the present surety bond guarantee size standard continue to control size eligibility of Surety Bond Guarantee Program applicants.

While not necessarily harmful, the actual effect of the bill's proposed revolving guarantee authority appears likely to confuse and frustrate at least the proponents of this concept. Whatever the level of bond guarantees this arrangement might authorize at any given time, SBA's ability to utilize it will still be limited by the real dollars available through Congressional appropriation through the revolving fund from which claims payments are made.

Accordingly, we recommend this provision be stricken from the bill.

This completes my summary statement, Mr. Chairman. Our full statement contains some additional recommendations which are technical in nature and concludes that SBA would support S. 2259 if changed to adopt our comments and recommendations.

[The prepared statement of Mr. Holloway follows:]

SBA U.S. Small Business Administration Washington, DC 20416

STATEMENT OF
EDWIN T. HOLLOWAY
ASSOCIATE ADMINISTRATOR
FOR
FINANCE AND INVESTMENT
BEFORE THE
COMMITTEE ON SMALL BUSINESS
UNITED STATES SENATE
April 12, 1988

Mr. Chairman, we thank you for inviting SBA to testify on S. 2259, a bill to expand the availability of surety bonds for small business concerns. Accompanying me today are Robert G. Lineberry, Deputy Associate Administrator for Investment and Howard F. Huegel, Director, Office of Surety Guarantees.

The enactment of Public Law 91-609, the Housing and Urban Development Act of 1970, evidenced the intent of Congress:

> "to strengthen the competitive free enterprise system by assisting qualified small business concerns to obtain bid, payment, or performance bonds which are otherwise unobtainable without an SBA guarantee."

SBA's Surety Bond Guaranty (SBG) program has permitted small concerns to obtain in excess of 200,000 contracts valued at more than $17 billion from inception of the program in 1971 to December 31, 1987. Initially, it was expected that the existing standard surety industry would write the bonds which SBA guaranteed. This expectation did not materialize for a variety of reasons, prominent among which were obstacles which this proposed legislation is designed to cure:

(1) Paperwork occasioned by SBA's need to document its administration of the program "on a prudent and economically justifiable basis" [15 U.S.C. 694b(h)]. This paperwork increases the expenses of the sureties for bonds written for contractors which are the smallest, and for which the required bonds involve an inordinately high degree of risk and high loss ratio; and are therefore less profitable or unprofitable;

(2) Resentment by the standard sureties, with their seasoned and experienced staff, that an SBA staff member would reject a proposed bond guarantee because SBA perceived that the statutory requirements of a likelihood of successful completion of the contract at reasonable cost and under reasonable bond terms [15 U.S.C. 694b(a)(4)-(6)] were not met.

The second impediment, in particular, discouraged the standard sureties which had, by proposing their bond for SBA's guarantee, represented that the bond was appropriate to the contract requiring it [13 CFR 115.6(a)].

The failure of the standard sureties to participate with SBA fostered the formation of a specialty surety industry which, to this date, writes the bulk of SBA-guaranteed bonds, often at a higher premium than a standard surety would charge. In fact, just ten such companies presently account for over 95% of the program's volume. While the success of SBA's bond program is satisfactory, there can be no doubt that a greater participation by the standard sureties would benefit small business by making bond guarantees available through their large Agency networks and their particular interest in using this proposed new authority to assist minority contractors.

After extensive consultation with the standard surety industry, SBA, in 1987, proposed legislation which would make only one substantial change to the statute: It would amend Section 411 of the Small Business Investment Act of 1958 (Act) to permit SBA to delegate underwriting and claims activities to selected sureties. The amended statute would authorize SBA to let selected sureties capable of monitoring and servicing their bonds themselves, make underwriting determinations and, on such basis, authorize these sureties to issue and service such bonds. The requirements of prudent and economically justifiable administration of the program would remain, and would be reinforced by imposing a maximum of 70 percent of their loss on SBA's guarantee to these selected sureties, whereas sureties not so selected would continue to receive 80 percent guarantees under present regulations. This proposal is, for ease of reference, called "Preferred Surety."

SBA would establish a set of criteria by which to qualify sureties for the "Preferred Surety Program," and such carefully chosen sureties would also be required to observe written surety underwriting procedures approved by SBA. These criteria and procedures would be maintained by stringent review, and evaluation of comparative loss ratios.

Any surety wishing to operate under present standards and procedures would, of course, be able to do so.

SBA is generally in favor of S. 2259, mirroring as it does, SBA's own views of the need for paperwork reduction and increased surety participation. However, S. 2259 includes tiered guarantee authority, based on whether a contractor's status would be deemed socially and economically disadvantaged. Specifically, it proposes a guarantee not to exceed 70 percent for contractors guaranteed under the Preferred Surety Program, a guarantee not to exceed 90 percent for contractors participating under our current SBG program and a guarantee equal to 90 percent for small business concerns owned and controlled by socially and economically disadvantaged individuals, whether their bonds are guaranteed under the Preferred Surety program or under our present SBG program.

SBA strongly objects to the proposed Section 411(c) (3). It should be noted that the Preferred Surety legislation proposed by SBA, and supported by the standard surety industry contemplated a guarantee no higher than 70 percent for such sureties and is designed to be an entry vehicle for minority contractors into the standard surety industry. A higher guarantee percentage is not required to encourage greater participation and bonding of disadvantaged contractors by standard sureties, as long as the other Preferred Surety concepts (delegated authority, eligible and qualified sureties, reduced administrative expense) are adopted.

SBA has by regulation reduced its guarantee at present to 80 percent. By so doing, SBA has expanded its universe within alloted guarantee authority with little or no apparent objection from either the contracting or surety industries.

At any level of guarantee, a surety company is reluctant to write bonds on a business it believes will cause a loss, since any loss far outweighs premium income. Even at a 90 percent guarantee, a surety experiencing a bond penalty loss will, on that bond, sustain a net loss ratio, at today's SBA rate, of almost 700 percent. For example, on an average $100,000 bond, a specialty surety's premium income will amount to $1,440 after payment of SBA's share of premium collected. The surety's share of a total bond penalty loss with a 90% SBA guarantee would be $10,000, which is 700% of the premium income.

The key to underwriting acceptance or rejection by surety companies in the program is not a tiered guarantee, but rather a surety's perception of the viability and chance of success of its bond clients. A 90 percent guarantee will not assist the disadvantaged business which a surety believes will fail. Nor will the present 80 percent guarantee or the proposed 70 percent Preferred Surety guarantee disenfranchise the business which the surety believes will succeed since the surety believes that the guarantee will not be utilized on that case.

If a surety could identify at the start those cases which would have losses, it would need no guarantee at all as it would not accept such cases. The surety requests the guarantee as a measure of protection on its book of business, not as loss reduction on an individual case. The industry, at present, perceives an 80 percent guarantee (70 percent for Preferred Surety) as being sufficient protection to encourage and enable its participation.

For both surety and SBA, determining the disadvantaged status of a contractor as a precondition to guarantee level eligibility would be an additional and time-consuming burden which also would be counter-productive to increasing access to the program by small contractors, disadvantaged or not. By the time the question of disadvantaged status had been resolved in a prudent manner, so as to protect the Government from "shadow" and "front" companies, the time for bidding might well have passed, and with it the opportunity the SBG program was originally designed to give the small contractor.

Given the foregoing factors and that the Surety Bond Guarantee Program already has approximately 25% minority contractor participation, it is our belief that this proposed change is not likely to measurably increase participation by disadvantaged contractors. Further, it is difficult to respond to the question on this point in the committee's letter of invitation because we do not know the numbers or types or condition of disadvantaged contractors which the Committee believes to presently be precluded from obtaining surety bonds.

The annual audit provision of proposed section 411(g)(3) should be stricken. SBA's manpower is insufficient to such task, which would involve the largest insurance companies in the country. The appointment of non-SBA auditors is impractical because they would lack the specialized expertise (e.g. determining disadvantaged status). Finally, and most importantly, proposed section 411(g)(2) - present section 411(g) - gives SBA the authority to audit participating sureties "at all reasonable times."

The bill amends Sec. 411 of the Act by introducing additional wording dealing with size standards. SBA has concluded that the size standards presently applicable to the SBG program are adequate and practical and should be retained as the controlling size standards for SBG eligibility. To do otherwise would be to impose upon the surety companies (which are the first contact with the small business) an unworkable burden of size determination, while the present SBG size standard is simple as well as easy to administer and control. As with the comment on disadvantaged status, it must be remembered that the approval process is very time-sensitive for the contractor, surety and SBA alike. Simplicity of administration is essential to meeting the frequently tight time-frames involved.

The Bill also proposes that SBA establish a revolving fund for guarantee authority similar to the revolving fund currently operational for claims payment. The proposed amendment to Section 412 of the Act would, in our view, not achieve the intended result and should be deleted. Regardless of the authorization level, or in the absence of any ceiling on authorization, the funds actually appropriated and available as reserve for losses would continue to control the volume of bonds that can be guaranteed by SBA.

Additionally, we have the following technical suggestions and comments on the wording of this bill:

- The Findings discuss the SBG program entirely in terms of construction contracts. The word "construction" should be stricken in all five places, since the SBG program also deals with other types of contracts.

- The Finding (9)(B) should focus on outgrowing dependency on SBG guarantees, not just SBA size status. It should be changed to read, "once they outgrow their need for an SBA guarantee in order to get bonds"

- Purpose (1) should read "... delegates to selected participation companies ..." and " ... claims administration decisions ..."

- Purpose (2) should be stricken in accordance with our previous comments.

Sec. 411(a)(1) should read "or bonds ancillary thereto ..."

- Sec. 411(a)(4)(A) should read " ... principal under the bond ..."

- Sec. 411(b)(5) should read "... exceeding the SBA guaranteed share of the penal sum available to ...." since there is technically no maximum amount of the bond guarantee.

- Sec. 411(c)(2) should read "not to exceed 90% of the loss incurred and paid in the case of a surety requiring the Administration's specific approval of a guarantee; in no event shall SBA make duplicate payment under subsection (b) and other subsections;"

In conclusion, SBA would support S. 2259 if changed to adopt the comments and recommendations we have provided in this statement.

Senator NUNN. Let me go back now. You support going from 80 percent to 70 percent where the company is using its own pen?

Mr. HOLLOWAY. Yes, sir, we do.

Senator NUNN. How often do you believe that has to be monitored? How closely supervised do you believe that provision should be in terms of administration?

Mr. HOLLOWAY. I note, Mr. Chairman, that we start off here with a 3-year pilot, and in terms of the program development that is necessary to get anything of this nature going, I do not anticipate a rocket startoff to this. We will make a start, and as the volume grows in the Preferred Sureties Program, as I believe it will, then we would give it more attention.

However, by adopting the criteria that has been indicated would be a part of this process, we believe that this program can grow effectively and responsibly and is a very positive step.

Senator NUNN. Are you going to have a lot of front-end examinations to determine which companies should qualify?

Mr. HOLLOWAY. I do not believe we will have a lot of front-end examinations, per se. What we will do is through the regulatory process adopt some reasonable criteria and go to final regulations and use that criteria.

It has been suggested by Mr. Provost in his testimony that a number of particular criteria be used. Those are very good criteria, we believe, and indeed have worked with the sureties over the past few years in an attempt to reach some consensus about the type of thing it takes to adopt a criteria that would admit certain sureties to the program and exclude others from the program.

Senator NUNN. How much additional risk do you think the Government is going to have by not having these bonds reviewed by the SBA on a case-by-case basis?

Mr. HOLLOWAY. I do not believe that we will have significant additional risk. I would compare it briefly to our preferred lenders program under the 7(a) Guarantee Program where we do a similar thing.

We find that with our most successful lending partners coming into that program, we very effectively operate a relatively low loss and low resource program, low resources in terms of what the Government puts into it. I believe the same thing will happen here.

Senator NUNN. Let us take the pool of existing guaranteed loans now. Say this is the pool.

Do you think that pool is going to expand under this provision? Do you think there are going to be more guarantees with a larger program, or do you think you are going to have the same size pool with a different allocation between specialty companies and standard companies?

Mr. HOLLOWAY. Well, certainly the total number of small businesses assisted and the total number of bonds issued would be somewhat greater. The greater we use the 70 percent guarantee rather than the 80 or the 90 percent guarantee, I believe over time, as happened again with the 7(a) preferred lenders program, the total volume that can go through that program and harness up the private sector and the public sector in that particular mode will increase.

Probably starting out, we would be very lucky to do in a first year in a pilot perhaps somewhere between 10 and 20 percent of our total volume through this Preferred Sureties Program.

But over time, as people became comfortable with it, as we debug the program for whatever bugs we put into it starting out, there will be a healthy growth. Right now, in fact, between our certified lenders and our preferred lenders, we are doing over half of our total activity in the 7(a) Program through the certified lenders and preferred lenders programs.

So these techniques, a partnership between the public sector and the private sector, given them——

Senator NUNN. We already have a pretty good road map on that.

Mr. HOLLOWAY. We have a very good road map, Senator.

Senator NUNN. What about the revolving fund, now? I am not sure I understood exactly your position on that.

Mr. HOLLOWAY. Our position, Mr. Chairman, is essentially that, stripped of the form of adopting a revolving account, that all we are really saying is let us increase the authorized amount and let us increase the appropriated amount.

For any authorized amount, whether we recycle the guarantees for completed contracts or not, we have the limitation of our appropriations. That is really going to determine in the final analysis.

We have certain factors that relate the total amount of approvals to the total amount of appropriation that is going to be needed. If through the technique of a revolving account we simply increase the total amount of approvals, then we are either going to have to raise the appropriation or we are going to have to adjust our factors that relate the authorization amount to the appropriated amount.

Senator NUNN. We are trying to give more stability to the program. Do you have other ways to give more stability to the program that you can suggest?

Mr. HOLLOWAY. I believe that the annual authorization and appropriation and hearing process provide us about as much opportunity to have that as anything that I could come up with, Mr. Chairman.

Senator NUNN. What about the 90 percent? What is your position on the 90 percent?

Mr. HOLLOWAY. Our position on the 90 percent is very much in line, I believe, with what I heard as testimony here this morning.

I certainly commend the Chairman and his staff on the panel of witnesses that you brought forward here, because I thought that this was a very knowledgeable and articulate panel of witnesses. They made a lot of good points.

I was particularly impressed by Mr. Curtin's articulation of the point that suretyship is a judgment business and not a risk business. I am not saying there is no problem. I am saying that the problem, if any, is not a problem that is traceable to the level of guarantee.

The real problem, I believe, is the problem of getting access to the standard sureties market for small business concerns, both disadvantaged and nondisadvantaged. I believe your bill addresses that problem.

Senator NUNN. Are you saying that if the 70 percent/write with your own pen kind of provision works that the 90 percent becomes less important or nonimportant?

Mr. HOLLOWAY. Yes, sir.

Senator NUNN. I believe ASA suggested this morning going from $1.25 million to $1.75 million in terms of the authorized amount of the guarantee.

What is SBA's position on that?

Mr. HOLLOWAY. Mr. Chairman, we note that there has been a recent increase from $1 million to $1.25, and we note that the average amount of our bond guarantees is around $100,000, perhaps as much as $105,000 to $107,000. To start it has been around $85,000. So our range here is probably something like $95,000 to $105,000.

I guess I would have somewhat of a bias toward being sure we can accommodate those bond guarantees that are needed in the area of our average bonds so that we can assist more small and disadvantaged businesses and receive that guarantee rather than try to direct more of our guarantee to our larger bond requirements.

Senator NUNN. We are talking about the overall level here now. If this really works and if you do have the big companies come in and go through a procedure that leads to a lot more being written, then you are going to need some additional authority, are you not?

Mr. HOLLOWAY. Well, we may very well, Mr. Chairman. I believe, again, that since this will not take off like a rocket that it will not outstrip the ability of this Committee and the Congress and the executive branch to monitor this on a yearly basis and accommodate the real need that is out there.

Senator NUNN. How about fiscal year 1989?

Mr. HOLLOWAY. In fiscal year 1989 we are proposing again, I believe, $1,250,000 billion, are we not, and that from our experience this year when it looks like we are going to be about $1 billion, we would believe that the $1,250,000 billion, proposed in the fiscal year 1989 budget is adequate.

Senator NUNN. Did you have this program in mind when you proposed that budget?

Mr. HOLLOWAY. Yes, sir. We really had this program and this concept in mind for several years. So we have had it in mind and believed that it was moving forward to this.

Senator NUNN. Thank you.

Mr. Lineberry, do you have anything to add? Mr. Huegel?

Mr. LINEBERRY. Not at this time, Senator Nunn.

Senator NUNN. Mr. Holloway, anything else?

Mr. HOLLOWAY. No, sir.

Senator NUNN. Thank you very much for being here.

Mr. HOLLOWAY. Thank you.

Senator NUNN. We appreciate it. We look forwarding to working with you as we continue to move on this legislation.

Mr. HOLLOWAY. We look forward to working with you.

Senator NUNN. The Committee will stand adjourned.

[Whereupon, at 10:40 a.m. the hearing adjourned.]

APPENDIX

**CONTRACTORS BONDING
AND INSURANCE COMPANY**

April 13, 1988

Ms. Tracy Crowley
Hearing Clerk
440 Russell Senate Office Building
U. S. Senate
Washington, D. C. 20510

Re: Senate Bill 2259

Dear Ms. Crowley:

On April 12, 1988, there was a hearing on Senate Bill 2259, at which a representative of the American Subcontractors Association ("ASA") testified. As I understand it, ASA testified that the appropriation level should be raised from $1.25 billion to $1.75 billion in order to address capacity problems with respect to the availability of bonding for small contractors. We strongly support the ASA recommendation, feeling, that with the large number of small contractors in need of bonding, the increased limit is absolutely necessary to service the small contractor industry.

Very truly yours,

CONTRACTORS BONDING AND INSURANCE COMPANY

By: ______________________
Steven A. Gaines, President

SAG/k

ColC04c

P.O. Box 9271, Seattle, Washington 98109-0271
Corporate Offices:
Waterfront Place One, 1011 Western Avenue, Suite 904, Seattle, Washington 98104-1090
(206)622-7053 National Wats: (800)426-9949 FAX: (206)682-1558

SOUTHEASTERN INSURANCE GROUP

RONALD M. PRUPIS
Chairman of the Board
Chief Executive Officer

MEMBER COMPANIES:
Southeastern Casualty & Indemnity Insurance Company, Inc.
Southeastern Casualty & Indemnity Insurance Company of New Jersey, Inc.
Southeastern Reinsurance Company, Inc.
Southeastern C & I Financial Services, Inc.
Southeastern Financial Planning Group
Southeastern Mortgage Company
Contractors Performance Corporation
The Major Mortgage Company of the Southeast

April 11, 1988

Committee on Small Businesses
United State Senate
Washington D. C. 20510-8350

To Whom It May Concern:

Southeastern Casualty and Indemnity Insurance Company has been very successful in providing bonding to small and medium sized contractors throughout the nation.

A 90% guarantee from the Small Business Administration will allow companies like Southeastern Casualty & Indemnity Insurance Company to better serve these small and medium sized contractors due to the fact that the statutory surplus of companies like Southeastern Casualty & Indemnity Insurance Company would be greatly enhanced because of the reasonable cost to the participating companies for the coverage.

Sincerely,

Ronald M. Prupis

499 N.W. 70th Avenue, Suite 200 • Plantation, Florida 33317 • (305) 581-8100
Toll Free 1 (800) 621-3397 • In Florida 1 (800) 331-4508 • Telecopier (305) 583-6336